The Incorporated Accountants' Journal

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The Society of Incorporated Accountants and Auditors

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Vol. XLIV AUGUST, 1933 No. 11

Contents.

	PAGE
Professional Notes	383
The Fourth International Congress on Accounting :—	
Article on	386
Report of Proceedings :	
President's Address of Welcome	387
Paper on International Finance by Sir Josiah Stamp	389
Paper on Exchange Fluctuations in Accounting by Mr. A. E. Cutforth	399
Paper on Holding and Subsidiary Companies by Sir Albert Wyon	413
Banquet in the Guildhall	425
Papers on Auditors' Responsibilities :	
The British Point of View, by Mr. Henry Morgan	431
The Continental Point of View, by Dr. W. Voss	443
The American Point of View, by Col. R. H. Montgomery	451
Social Functions	467
Officers, Delegates and Visitors and Members of Sponsoring Bodies	468
Society of Incorporated Accountants and Auditors :	
Membership	386
South African (Eastern) Branch : Annual Dinner and Annual Meeting	470
Incorporated Accountants' Students' Society of London and District	469
Municipal Corporations (Audit) Act, 1933	469
Changes and Removals	472
Income Tax Question : Rent Payable to a Partner	472
Review	473
Society of Incorporated Accountants in Ireland	473
District Societies of Incorporated Accountants	473
Cost of Municipal Hospitals	473
Scottish Notes	473
Legal Notes	474

Professional Notes.

ALTHOUGH the Fourth International Congress on Accounting has closed its proceedings in London, the fact must not be overlooked that the delegates are on visits to Scotland and Ireland during the last week in July. Interesting programmes have been arranged for the reception and entertainment of the visitors, and all those who have experienced Scottish and Irish hospitality will realise the opportunities afforded by the sponsoring bodies of accountants in both countries for visiting them under ideal conditions.

We publish this month a number of the papers which were read at the Congress together with the discussions thereon. The following papers will appear in later issues :—

"Capitalist Combinations in Industry—in the Light of Present-day Needs." By Mr. C. Hewetson Nelson, F.S.A.A.

"The Control of Charges and Profits of Statutory Undertakings, in Private or Public Ownership and Accounts relating thereto." By Mr. William Cash, F.C.A.

"Accounting as an Aid to Commerce." By Professor W. Annan, C.A.

"Mechanical Accounting." By Mr. Robert Ashworth, F.C.A., F.S.A.A.

"Depreciation and Obsolescence ; Methods of dealing with the same, including Annual Appraisals." By H. G. Howitt, F.C.A., and Mr. A. S. Fedde (United States of America).

At the Congress of Chambers of Commerce of the British Empire held in London during July, resolutions were adopted dealing with Arbitration Rules and Bankruptcy Law. In regard to Arbitration, the Congress urged Chambers of Commerce generally to endeavour to popularise the model Arbitration rules instituted by the Federation of Chambers of Commerce, and thus assist towards placing Arbitration throughout the Empire on a sounder footing.

The Congress also thanked the Bankruptcy Committee of the Federation for so successfully accomplishing the task of producing a "Digest of Bankruptcy Law in the British Empire," thus supplying the commercial community with necessary information in a succinct form. The Congress called special attention to the recommendations contained in the Introduction to the Digest concerning the need for uniformity and the best means of bringing it about.

The Minister of Health (Sir Hilton Young) has appointed a Departmental Committee to consider and report on the question of the capital cost of construction and the annual cost of maintenance of certain classes of public buildings provided by local authorities, namely, hospitals,

public assistance institutions, mental deficiency institutions, maternity homes, &c. Among the members of the Committee appointed by the Minister is Mr. John Allcock, O.B.E., F.S.A.A., for many years City Treasurer and Controller of Cardiff, and a valued worker for the Society of Incorporated Accountants and Auditors during the last forty years. Mr. Allcock is equally well known for his services to the Institute of Municipal Treasurers and Accountants, of which he is also a Fellow.

Mr. F. G. Bowers, C.B., C.B.E., A.C.A., of the Ministry of Labour, has been appointed Comptroller of the London County Council. The transfer of a member of the Civil Service to a Municipal office is somewhat of a novelty, but Mr. Bowers is an excellent choice in every way. During the War he rendered valuable services at the Ministry of Munitions and is known to those associated with him for his broad outlook and wide sympathies.

General regret will be felt in the profession at the retirement from the Civil Service of Mr. H. C. Souter, I.S.O. Mr. Souter was head of the Returns and Statistics Branch of the Registry of Friendly Societies and his name has been prominently before the public in regard to the searching inquiries he has conducted from time to time into the affairs of certain friendly societies which have not carried on their operations in a manner to justify public confidence. In his retirement he will take with him the cordial good wishes of those who have professional relations with his former Department.

It is not unusual for accountants to accept nomination as trustees under wills and other trusts on the understanding that they are to be paid their proper professional charges for the work they have to do. In this connection it is necessary to see that the clause in the will dealing with the matter is worded widely enough to enable the accountant to be remunerated for the whole of his time. In the case of *re Chalinder and Herington* (1907), Mr. Justice Warrington stated the position thus: "It seems to me that in order to enable a solicitor-trustee to obtain payment for work for which an ordinary trustee could neither be paid directly nor be allowed payments made to a solicitor, there must be words in the will which will show that this was the intention." The same remark would of course apply to an accountant and it would thus appear that his charges might be restricted unless the power is very widely worded. What would be necessary would be to include a provision giving authority to charge for matters which might or should have been attended to in person by a trustee who was not an accountant or other professional person.

The Association of Chambers of Commerce have issued a report dealing with the question of income tax allowances for obsolescence and replacements of plant and machinery as to which they claim that the present income tax law is in keeping neither with equitable principles nor with sound commercial practice in ascertaining the true profits of a business. It is accordingly claimed that the existing law should be amended so as to bring the allowance for obsolescence already operative into line with the wear and tear allowance, by giving the taxpayer an increased annual allowance, and that the total allowance for obsolescence thus arrived at should be capable of being carried forward when the year's profits are not sufficient to permit its deduction. It is also claimed that when plant is scrapped, and whether replaced or not and whether worn out or not, then in so far as the total annual allowance for wear and tear and obsolescence, together with the scrapped value of the plant, do not amount to the full original cost, the difference should be allowed as a deduction from profits so long as the business is not discontinued.

In addition to setting out fully the income tax provisions relating to the allowances in respect of plant and machinery which are now operative, the report contains a reasoned statement as to why the additional allowances which are claimed should be made. It also advocates that the portion of the profits of a business which is spent on capital extension should receive some relief from income tax.

The report of the Chief Registrar of Friendly Societies for the year 1932 shows that the total number of audits conducted by public auditors during the year was 7,411 and that the average number of audits conducted by each auditor was six, the total fees charged amounting to £131,675. These figures correspond very closely to those of the preceding year. It is pointed out by the Registrar that there was again an increase in the number of audits conducted by public auditors for these Friendly Societies and that 89 per cent. of the public auditors are members either of the Institute of Chartered Accountants or of the Society of Incorporated Accountants and Auditors, as compared with 73 per cent. in the year 1920.

An income tax case of some importance came before Mr. Justice Finlay last month in the case of *Davies* (*Inspector of Taxes*) v. *Braithwaite*, which had relation to the affairs of Miss Braithwaite, the actress, in connection with her American tour. It was admitted or proved that Miss Braithwaite was a British subject and that during the years of assessment she was resident in the United Kingdom within the meaning of the Income Tax Acts, but it was contended on her behalf that she was not liable to be assessed under Schedule D on profits received by her from carrying on her profession outside the United Kingdom. She had no place of business in the United Kingdom, nor any agent, and while she was outside the United Kingdom she exercised and controlled her profession in the place where she was from time to time, the contracts being entered into while she was abroad. For the Crown it was claimed that Miss Braithwaite exercised her profession partly within and partly without the United Kingdom and, as she was legally resident in the United Kingdom, the whole of her profits wherever earned were taxable.

The decision of the Commissioners was that Miss Braithwaite's American earnings were not liable to assessment, but Mr. Justice Finlay, in giving judgment, took a different view. He said the matter admittedly came under Case II of Schedule D—" Tax in respect of any profession, employment or vocation not contained in any other schedule." It was clear in his opinion that Miss Braithwaite carried on one profession and not a series of professions. If she went on a tour abroad it could not be suggested that she was exercising one profession in Paris, another in Berlin and another in New York. The words of Schedule D included " the profits accruing to any person in the United Kingdom from any trade, profession, employment or vocation whether the same be respectively carried on in the United Kingdom or elsewhere." The claim made on behalf of Miss Braithwaite that the matter in dispute was essentially a question of fact on which the conclusion of the Commissioners was final, he did not admit, and he accordingly allowed the Crown's appeal.

A question came before the Court of Appeal last month, in the case of *Elliott* (*Inspector of Taxes*) v. *Burn*, which very strikingly illustrates the anomalies of income tax law. The appellants, Messrs. J. H. and F. H. Burn, who were surface owners of land in the county of Durham, granted another firm the surface liberties required for the working of seams of coal under the land, and subsequently, for a rent of £150 a year and a small royalty for every ton of coal worked, granted them liberty to work the coal. Considerable sums were received under these contracts without deduction of income tax and assessments were made on Messrs. Burn for the tax on those sums. The appellants had let the surface at a yearly rent of £296 to a farmer, who as occupier was assessed on that amount under Schedule A. The appellants contended (1) that they were not in occupation of the land and that income tax had been charged on the full value of the land under Schedule A (on the £296) and no further charge could be made, and (2) that the profits referred to were not profits in respect of any trade or profession within the meaning of Schedule D. The Crown on the other hand claimed that the payments under the contracts were profits or gains and that they were not part of the annual value of the land under Schedule A, but came under the heading of " all other profits not before enumerated arising from lands." (Rule 7 of No. 2 of Schedule A.)

The Commissioners held that the sums in question were not assessable and discharged the assessments, but their ruling was set aside by Mr. Justice Finlay, who held that they were " other profits arising from lands." The Appeal Court has now reversed Mr. Justice Finlay's decision.

The Master of the Rolls, in giving judgment, said the facts of the case were against the arguments of the Crown. The agreement under which the profits arose was not like the grant of a pathway or the right to run a tramway, or to make use of the land in any ordinary way. All that the agreement with the lessees said was, in effect, " I will not take proceedings against you to stop you working minerals." It was an agreement not to take proceedings and did not come within the provisions of the Income Tax Act, 1918. The profits did not arise from the land but were sums given to the owner to deter him from exercising his protective right to restrain the damage to the land. The appeal was accordingly allowed.

By the new Rent Restriction Act which came into operation last month some 500,000 houses passed out of control, and on a change of tenancy a further 1,250,000 houses will become decontrolled. Another group of houses (the lowest rented of those coming under the Rent Restriction Acts) will continue to be controlled for a further five years, whatever changes of tenancy take

place in the meantime, provided that they are registered with the local authority within three months. Should they not be so registered they will again become controlled subject to the Court being satisfied that there was a reasonable excuse for failure to register. An important provision in the Act is directed to the prevention of profiteering. Tenants must notify their landlords of any sub-lettings and of the rent that is being charged, and if this rent is found to be more than the recoverable rent the landlord may take possession of the house.

It sometimes happens that annuities are paid partly out of income and if the income is not sufficient the balance is paid out of capital. In such a case it has to be borne in mind that the deficiency made up out of capital becomes income in the hands of the annuitant. This was the decision of Mr. Justice Finlay in *Trustees of Brodie* v. *Commissioners of Inland Revenue*. He said it was clear that if capital sums were paid to an annuitant and received by the annuitant as income they were liable to income tax. It was immaterial what those sums might have been in the hands of the trustees who paid them.

THE FOURTH INTERNATIONAL CONGRESS ON ACCOUNTING.

THE issues of the *Incorporated Accountants' Journal* for this month and September will be devoted mainly to the proceedings at the Fourth International Congress on Accounting held in London from July 17th to 21st, under the Presidency of Lord Plender, with Sir James Martin as Vice-President, the Hon. George Colville as Secretary, and Mr. R. W. Bankes and Mr. A. A. Garrett as Assistant Secretaries. The Sponsors of the Congress were the eight bodies of accountants in England and Wales, Scotland and Ireland. The attendance comprised delegates from 28 countries throughout the world, and the proceedings can be regarded as eminently successful. There is no necessity on this occasion to review in detail either the papers which were presented at the business sessions together with the discussions thereon, or the social events which from all reports gave much satisfaction to the delegates, the visiting accountants from abroad, and the ladies who accompanied them. The beautiful setting of Westminster Abbey where, by kind permission of the Dean, a service was held to inaugurate the Congress, with an address by His Grace the Archbishop of York, fitly opened a week which closed in festivity with a Ball at Grosvenor House. The Banquet in the Guildhall of the City of London was honoured by the presence of H.R.H. Prince George, and the company which sat down to dinner in this ancient and historic building numbered not less than 700. The cordial thanks of all who took part in the proceedings are eminently due to the Executive Committee which organised the Congress in conjunction with the Secretary and the Assistant Secretaries. The papers presented to the Congress and discussed by those present to the extent of the time permissible will, when collated, form one of the most important volumes of accountancy literature which has ever been presented to the profession throughout the world.

Prince George in his able speech in the Guildhall said that it seemed curious to him that accountancy should not have been recognised as a definite profession from a much earlier date, as in the case of doctors and lawyers. "At the present time the necessity for good accountancy and of taking the advice of accountants was becoming more and more recognised." The pioneers of these International Congresses, the first of which was held in St. Louis, U.S.A., in the year 1904, had a wider range of vision than they realised at the time, and it is to their foresight that we owe this gathering in London, the extent and influence of which no one envisaged at the inaugural meeting. Many of the pioneers have passed away, but some happily are still with us, and in reviewing this Congress of 1933 we would remember with gratitude their early efforts.

Society of Incorporated Accountants and Auditors.

MEMBERSHIP.

The following additions to and promotion in the Membership of the Society have been completed since our last issue :—

ASSOCIATE TO FELLOW.

LOMAX, CYRIL MORTON (Lomax, Clements, Gladstone & Co.), 10-18, Newgate Street, London, E.C.1, Practising Accountant.

ASSOCIATES.

COXON, LOUIS STANHOPE, Clerk to Nutt & Horne, St. James's Chambers, Derby.

DESHPANDE, ANANT VENKTESH, formerly Clerk to Dalal & Shah, 70, Medows Street, Fort, Bombay.

KENYON, FLETCHER, Clerk to F. T. Kenyon, Midland Bank Chambers, Penrith.

KERR, ROBERT, Clerk to Frank W. Hanson, Court Chambers, Jessop Street, Castleford, Yorks.

SQUIRES, JACK EDMUND, Clerk to H. Slater & Son, Sussex House, Hobson Street, Cambridge.

International Congress on Accounting.

THE Fourth International Congress on Accounting opened in London on Monday, July 17th. Prior to the business proceedings, the delegates and members attended a service in Westminster Abbey. The service was conducted by the Dean of Westminster and the sermon was delivered by the Archbishop of York. The Archbishop took as his text the words, "Seek ye first the Kingdom of God and His righteousness"—or His justice—"and all these things shall be added unto you." In concluding, the Archbishop said that upon their profession, and the conduct of its responsibilities by its members, must very largely depend the basis of mutual confidence, which was the first condition of returning or abiding prosperity. It was because they knew that full well that they had come to the Abbey in order that in the course of their deliberations, and at their very outset, they might remember that other great factor which was the primary necessity of man's welfare—the sense of dependence upon God for guidance and for power. Surely the very holding of that service was of good augury, not only for their Conference, but for the future of the world. For they, upon whom so much depended in those various countries which they represented, had come to seek the guidance of God and to confess their dependence upon Him in their work of maintaining among those who conducted the world's business, mutual confidence and trust.

PRESIDENT'S ADDRESS OF WELCOME.

The business proceedings of the Conference commenced on Monday afternoon at Grosvenor House, under the Presidency of Lord Plender, G.B.E., F.C.A., when messages of goodwill were read from accountants and accountancy bodies from various parts of the world.

The PRESIDENT, who was received with applause, said: Twenty-nine years have passed since the first International Congress on Accounting was held in St. Louis, U.S.A. A period of 22 years elapsed before the second Congress took place in Amsterdam in 1926, and this was followed three years later in 1929, when the third Congress was held in New York. After four years the Congress now meets in the capital City of the British Empire, and it affords the members of the profession in Great Britain and Ireland an opportunity—which we warmly welcome—of renewing friendships and making new friends with our professional brethren from overseas. (Applause.) We recall with great pleasure the courtesy and hospitality extended to us at previous Congresses; we are appreciative of the acceptance of our invitations by so many delegates from abroad, and it is our earnest hope that this Congress may strengthen the cordial relations which exist between the organised bodies of practising accountants throughout the world. (Hear, hear.)

The number of appointed delegates and the members of accounting bodies attending each of the Congresses and the size and contents of the volumes which record the proceedings demonstrate the interest of the accountancy profession in such gatherings. The volume of the St. Louis Congress contains 220 pages, that of Amsterdam 850 pages, and the New York volume 1,376 pages. Whilst it may be found that the book which will be published as a record of the proceedings at this Congress will not compete in size with the last two volumes, yet it may be not less helpful, as the subjects selected for addresses and discussions cover a comprehensive field. It may be said that some of the addresses are of special interest to the profession in this country, but we believe they will also prove to be of real value to those present from other countries. We have been fortunate in securing the co-operation of eminent accountants both in Great Britain and from abroad in uniting to give us the benefit of their views on the subjects selected, and there will be, I hope, ample opportunity for useful discussion. The period available for the Congress did not permit of any enlargement of the business programme without curtailing the time which should be devoted to the consideration of the papers and at the same time give some reasonable relaxation by way of visits to places of historic interest.

It would be inappropriate for me in this address of welcome to anticipate the proceedings of the Congress, but it may not be out of place if at this stage I address to you, *inter alia*, a few general observations upon certain ethical principles and aspects of professional duties and obligations which should have universal application. Accounting as an organised profession is of comparatively recent growth and originated in Great Britain. Yet within a few decades it has increasingly established itself throughout the world in the estimation and confidence of Governmental Departments and municipalities and public authorities and of the business community and the investing public. We owe much to the wisdom and foresight of the pioneers of the profession who founded it upon a code of ethics adherence to which has in no small measure contributed to the position we occupy to-day, and it is well on an occasion like this that we should pay a tribute to their memory. (Applause.)

Mutual esteem and respect between our members must be based, not only upon the professional ability we show and the reputation we enjoy individually, but also upon the maintenance, under the ægis of our respective organisations, of a high standard of professional rectitude. The vast public whom we

serve as clients form their judgment of the professional status of accountants from their contact with our members, and it is the character of the individual members which alone can uphold the traditions and prestige of the bodies to which we each belong. It is the province of our respective organisations, by whatever name they may be called, to preserve by examinations a high level of professional knowledge and training essential to secure admission to membership, and also to ensure, as far as disciplinary action can do, that no member by his acts or omissions shall escape the consequences of conduct which would bring him, and through him the profession, into disrepute. (Applause.)

But apart from these fundamental duties which devolve upon those members who constitute the executives of our respective organisations, it should be the personal obligation and privilege of all practising accountants to initiate and encourage frequent intercourse with one another for discussion and exchange of views as a means of increasing our own usefulness, of enhancing the reputation of the bodies to which we belong, and of making the profession as a whole more helpful to the community. And particularly do such personal contacts foster the spirit of right conduct between practising accountants themselves. (Hear, hear.)

Unofficial committees or panels having no official connection with the governing bodies exist in various important business centres or districts. Any practising accountant who finds himself in a position of doubt or difficulty concerning a professional matter can consult confidentially the members of such a committee who are frequently in a position to give him most helpful advice. The value of such advice, especially to a young accountant whose experience is necessarily limited, can well be appreciated.

The accountancy problems to be considered at the Congress cover a wide area, and the application of the principles involved is in many respects international. But it must be remembered that the laws of countries differ in regard to the books of account to be kept; judicial dicta vary as to the responsibility of directors and of auditors respectively; form or architecture in the compilation of balance sheets and profit and loss accounts differs; the functions of auditors and the scope of their duties do not always bear a resemblance in countries with different conceptions of what is required of auditors, and to expect international uniformity in all these respects is impracticable. Notwithstanding these differing conditions, there would, I think, be agreement that the goal of attainment everywhere lies in clearly stating material facts in balance sheets and profit and loss accounts, and the subject will be fully ventilated at the Congress.

Another matter of international interest is that of holding companies, and the treatment of profits and losses of subsidiary companies. The rapid growth in comparatively recent years of this movement, particularly in this country and in the United States of America, gives rise to accounting problems and principles of great importance, and they will form during the Congress a subject of fruitful deliberation. There are other papers relating to exchange fluctuations, depreciation and obsolescence, finance, public utility undertakings, &c., that also have international characteristics. We hope that all the papers will provoke the comments of delegates and visitors, and lead by mutual exchange of views to clear understanding and a considerable measure of accord in the fundamental principles to be followed in the treatment and preparation of accounts. But no resolutions will be submitted to the Congress affirming any particular views as recommendations for the profession as a whole.

I have alluded to the benefits available to members of the accountancy profession in this country in being able to consult unofficial committees in regard to professional matters, and I have also referred to the benefits which we all hope to obtain at and from this Congress by the exchange of experience and views and by a study of the valuable papers which are to be submitted. These considerations lead me to wonder whether any means could be devised of pooling knowledge of the practice which obtains in various countries where accountancy has become organised. It may be said that subjects of international interest have already been dealt with very fully in addresses and books which are available to the diligent seeker. But they are widely scattered and are not accessible to accountants in all countries, and not too readily found even in the country of their origin. What is wanted is to bring together in concise and clear form essential material information concerning the relevant law and accountancy practice in each country as affecting matters of common interest to the profession throughout the world and to keep such information revised to date so that it embodies new legislation, recent decisions of the Courts, and the latest experience. Volumes so compiled would form a compendium of universal interest and be of great value to practitioners in each country.

Our profession grows in importance year by year. In the complexities of modern business there are hardly any directions in which our experience and advice may not be of value in connection with financial policy, the form and presentation of accounts, or in relation to effective methods of record, control and organisation. Government Departments constantly seek our advice and assistance on matters with which we are specially qualified to deal. Investors are influenced by our certificates in prospectuses offering securities for subscription. Shareholders in public companies look to us to watch their interests as far as it is within our power to do so. We are not guarantors or insurers in connection with accounts which we examine and report upon and we are not infallible; but if we are honest with ourselves and not afraid of expressing our opinions after careful and thorough inquiry, and with sound and well-balanced judgment, we shall serve our clients faithfully and maintain the prestige of our profession. (Applause.) And whilst the discovery and proper statement of facts should be our aim, we cannot neglect vision in our outlook and service.

As national prosperity increases—which is in no small measure affected by international trade—so does accountancy flourish. Any influences which contract business are not to our advantage, and we in common with all sections of the community earnestly desire to see a restoration of healthy and sustained activity in commercial and industrial enterprise. But the people of all nations are suffering from high taxation, and as a consequence, industry is crippled and developments retarded; budgets are unbalanced; free interchange of commodities is impeded by high tariff barriers; unstable exchanges make trading between many countries almost impossible; Government subsidies to support commercial ventures that compete internationally give unfair advantages to those so assisted, and anything approaching uniformity in world policy on these and other cognate questions seems at present incapable of attainment. Extreme nationalism which is the equivalent of isolation does not help the world in the crisis which confronts it, and it may be found that such a policy will not prove to be of ultimate good to the nations adopting it. (Hear, hear.) Still there is no reason to despair. Though difficulties, which are common to all nations, do not seem capable of solution by one great effort, yet arrangements made between groups of nations for their mutual advantage may pave the way to something more comprehensive.

There are some congresses or conferences which do not in achievement fulfil the expectations of their conveners. That will not be the fate of this Congress; we shall gather wisdom from the past, learn new truths from the present, discuss principles which are universal in their application, and with hope press forward—always striving, seeking and finding.

On behalf of the Sponsoring Bodies who are your hosts, I express, in conclusion, the hope and belief that when this Congress is over you will carry to your homes in far-off lands the happiest recollections and the good wishes of your many friends here. (Loud applause.)

Short Addresses of acknowledgment of the welcome extended to the visiting bodies were given by the following:

For Africa,
Mr. J. G. Carter, O.B.E., F.S.A.A., A.C.A Johannesburg.

For Germany,
Herr Dr. Wilhelm Voss.

For The United States of America,
Mr. John F. Forbes, C.P.A.

For Australia and New Zealand,
Mr. W. Appleton, F.R.A.N.Z.

For Austria,
Herr Fritz Spohn.

For Canada,
Mr. John Hyde, F.S.A.A., C.A.

For Denmark,
Monsieur J. P. Strobel.

For France,
Monsieur M. Barbut.

For Italy,
Signor Alfredo Selvi.

For Japan,
Dr. K. Fujimoto.

For Mexico,
Senor R. Casas-Alatriste.

For Norway,
Herr Christian Sommerschild.

For Holland,
Monsieur James Polak.

For Poland,
Monsieur S. Wojciechowski.

For Roumania,
M. le Prof. Gr. L. Trancu Iasy.

For Sweden,
Professor O. Sillen.

For Czecho-Slovakia,
Monsieur Ing. J. Fukatko.

On Tuesday, July 18th, a Paper was read on—

INTERNATIONAL FINANCE

BY

Sir JOSIAH STAMP, G.B.E., D.Sc., F.S.A.A.

Sir JAMES MARTIN, F.S.A.A., the Vice-President of the Congress, occupied the chair, and in introducing Sir Josiah Stamp, said they were extremely fortunate in having a speaker who was so well-known internationally to deal with a subject of international importance.

Sir JOSIAH STAMP said:—

The ink is hardly dry on any written discussion of modern problems of international finance before some kaleidoscopic shift of the world's affairs makes a new aspect dominant and brings to the front a different question of principle. We find left open as a matter for discussion whether a single metallic standard, like the gold standard, is capable of serving the double purpose of a stable standard of values for domestic and internal use in every country and an international medium of exchange for settling trade, financial and political balances. It has been seen that the presumptions of very considerable mobility of economic factors upon which the whole gold standard theory rests are at the moment unjustified so far as most civilised countries are concerned. The calls made upon these factors are extremely severe, if unsettled balances of international trade through intense economic nationalism, industrial planning and other changes in *laissez faire* are to prevail. The response of the factors instead of being greater, because of the greater demand, has become less. In other words, the existence of political payments for international debts, the desire to take no payments in the form of goods if possible, and an intensely sensitive set of money markets, where international financiers move money balances about regardless of the goods that ought to lie behind such movements, all mean that gold must be moved about more than it would be

in a less nationalist frame of mind, and a world where international finance was less mobile. For a gold standard to work in this situation satisfactorily, great adaptability of costs is required, especially in wages, and we all know that collective bargaining for wages and the attempt to get some stability of understanding, have moved this possibility in an opposite direction. Small wonder then that people dealing with the theoretic aspects of international finance have become doubtful whether a gold standard which depends for its success *either* upon complete *laissez faire, or* upon a very elaborate and well understood management, can succeed in a world where *laissez faire* is increasingly discounted and where the technique of international management is not yet elaborated. The minds of many thinkers on this subject gravitate, therefore, to one of two alternatives. First, to a choice between the importance of internal domestic stability against the interests of international trade (with a managed internal stable currency and fluctuating foreign exchange), or a fixed exchange and fluctuating internal prices. The second is some kind of duplicated mechanism whereby internal prices are ruled by one set of conditions and a special monetary standard, while gold or its equivalent remains the international medium, thus having finally a rate of exchange for domestic use between domestic currencies and the general currency. Now all these latter schemes, however ingenious, do not get away from the fact that quoting the dollar in an international unit, say, the gramme-or—and quoting the franc in the gramme-or—still means that there *is* actually a rate of exchange between the dollar and the franc that at one remove influences the trade between their two countries. It does not solve the problem of international trade, but merely tries to sublimate it, and enables us to focus attention upon domestic price levels. The problem of exchange in international finance is, in the long run, whether we can secure, by a single mechanism, stability of price measurement in each individual country, which will enable that country to function economically, and, at the same time, a medium of international exchange which will not unduly fluctuate. It has been very well said that the proportion of foreign trade to total trade in the U.S.A. is relatively so small that the United States should consider first the monetary mechanism of her domestic market, the price level that suits her, and let questions of foreign trade find their own level. But, on the other hand, that foreign trade matters so much to Great Britain, compared with slight differences of the domestic level of prices, that she ought to think first of the stability of sterling and only second of the convenience of the right level of sterling in her domestic market. Therefore, the United Kingdom can afford to let the United States choose the general level of prices first of all, provided that the States in turn will give the United Kingdom a good bargain, so to speak, on the parity of sterling. Now something like this is only emerging as the problem at the present moment, at any rate, so far as the United States is concerned. It must always be borne in mind, however for Great Britain, that it is not merely a question of the volume of foreign trade as such. One of the great services exported from Great Britain is a quality called *stability of value* in the sterling bill, and the services of a negotiating machine behind it. The use of the sterling bill, or quotations in sterling for insurance, &c., &c., is a valuable national asset, which we have been able to place at the service of the world. We have, therefore, much wider interest than merely the ability to exchange goods on satisfactory terms with foreign countries, and get them paid for. We have actually provided a convenient mechanism or means of exchange whose main characteristic in past years has been its stability over its period of life. Now it may still be thought by a large part of the world that sterling is likely to be more satisfactory as a currency tied to gold than as a currency managed by a Government and a Central bank, however well accredited and free from political pressure. We must expect to find, therefore, that all people who realise the importance of foreign trade and the services rendered by the City of London will have a natural leaning for a return to gold as the ideal state of affairs. They will be all the more confirmed in this course because of the absence of either experience or reasoned technique as to how currency divorced from gold is to be finally managed. They dread, however, a return to gold *without* certain preliminary understandings, if there is any risk of a collapse and a fall from grace a second time as unavoidable and as disconcerting as the first. They naturally say: "Great as our belief in the gold standard is, we would rather carry on as we are, managing our price level until these things can be settled, than make a precipitate and ill-considered arrangement."

The problems of international finance, therefore, range themselves in three degrees of urgency. The long distance one is—can a gold standard ever work satisfactorily in a world which is neither pure *laissez faire* nor pure control, but a curious mongrel mixture? If it can, what are the conditions of its working, and are they likely to be acceptable? What are the difficulties in each country which have prevented its working? If it cannot, what kind of arrangement do we seek domestically and internationally to take its place? Do we have a tabular standard, or a commodity dollar and commodity sterling, and what factors do we introduce into the measure of value? Do we base it on articles of international exchange, or does it include also entirely indigenous and domestic consumption? How do we wish domestic prices to behave? Should they fall and, if so, do they fall only with the increase in productivity per man hour? These are the long-range problems which the world will have to face.

The next line are the problems relating to the return to the gold standard and the immediate "rules of the game" that are necessary for that purpose. There is not the slightest doubt that if America had not gone off the gold standard through her domestic difficulties, the pressure upon us at this London Conference, with her influence joined to that of the Latin countries, would have been terrific. We should have been the world's bad boys, whereas

now we are in the position of sympathising with both sides and trying to bring them together with the City leaning to one and the West End leaning to the other. The immediate problem is how to maintain a reasonable framework of finance for foreign trade, while one important party to that trade and to world values is conducting a financial revolution and is giving no clear indication as to the point at which he would desire to hold it and within what range of action he can succeed. Is it possible to find a reconciliation between the domestic ambitions of President Roosevelt and the natural desire of the European countries to find a suitable basis of international trade, free from the fortuitous and disturbing elements of depreciated currencies in export trade, and free from the danger coming about through the movement of balances between financial centres, following "flights" from one currency to another. Before we embark upon any attempt to answer this, it is necessary to get clear a number of different notions which are hopelessly mixed up from time to time in the discussions.

THE URGENT PROBLEMS.

Apart from immediate recovery, the three chief underlying problems for the government of nations are—

(1) The balance between individual liberty and social direction. We have a natural philosophy of freedom and are continually modifying it to make our machine work. We are constantly putting larger and larger patches of social regulation upon the torn garment of personal liberty. In Russia to achieve success they are putting larger and larger gussets of personal liberty into the strait-jacket of economic communism.

(2) The cession of aspects of national sovereignty to international direction in economic questions.

(3) The measure of value—the monetary problem.

Money is known to us all as a—

(1) Medium of exchange; or

(2) Store of value; and

(3) Measure of value.

But we do not usually recognise that it performs the two first functions almost by mutual exclusion, for when it is being most used as a *store*, whether in a stocking or a safe, or an idle bank deposit, it is not serving to *exchange* goods. So its whole use is not really for both uses at once, but is divided between the two uses. But its third function, a measure of value, is not absolute—it depends upon the way in which the first two share the field. For if money is used a great deal as a store, and only to a minor extent as an exchanging mechanism, the "measure of value" will turn out to be quite different from what would result if money were used far *less* as a store and far *more* as an exchanging mechanism. The level of prices measured in money will be relative to these proportions between storing and exchanging. You cannot measure a yard with a tape measure if half of it is in your pocket. The money problem is a baffling blend of purely mechanical and equational elements with psychological and emotional elements. Upon its solution depends the whole possibility of a competent and highly-organised civilisation. It is being brought to a severe test in the present conference: failure might result from any one of the following:—

(*a*) The persistence of political nationalism in an economic world.

(*b*) Inability to suffer local disadvantages or changes for the greater common good.

(*c*) Inability to liquidate the past.

(*d*) Genuine difficulty in getting a common view about the "rules of the game" in a technical sense.

(*e*) Human reactions. While facts must prevail ultimately, what people think about facts may be even more important. If you think a credit machine unsafe, it *becomes* unsafe. You will run as fast from a dog that you *think* is a wolf, as a real wolf, and any risks attached to running are present in both.

The complications of the situation immediately before us in America and Britain depend, not upon two variables as most people often think, but upon three, and it is impossible to be clear which of these settles itself first. Certainly none is independent.

The first recognised variable is the *relation of the dollar to commodities*, the purchasing power of American currency, on which depends the price level in dollars, the ease or difficulty of making profits, and, therefore, the ultimate level of sound stock and bond values. This, therefore, determines the validity and security of their debt structure, mortgage and interest payments, the level of real wages, and the extent of their unemployment. It is to them by far the most important relationship that has to be explored, and they are taking important and novel steps to improve it and control it. Whether a rise of prices by itself will make all their debtor relationships quite comfortable without some adjustment in the amount of certain debts also I cannot say, but clearly the main burden of putting things right ought to rest upon the same agency that got them wrong, viz, a change in the dollar price level.

The *second relationship* we have to bear in mind is that between dollars and foreign currencies, especially those not on the gold standard, and I will express this, for convenience, as the dollar sterling exchange or parity. We have been asking, first, what is the "proper" exchange rate, and, second, what it ought to be fixed at, so as not to prejudice the foreign trade of either side or favour it unduly. Now, the "true" or proper rate depends on a parity or equality of purchasing power—the number of dollars that will purchase the same quantity of general commodities in foreign trade as a pound sterling. If this were not so, strange results would occur, and it is the natural "norm" to which the exchange rate tends, even if for other reasons it never touches it. It is clearly related to the internal or domestic price level, too. If the dollar is inflated or multiplied so that it buys less

commodities than before and prices rise, but sterling remains constant in its purchasing power, the United States may secure a more comfortable internal situation, but the number of dollars to be given for a £ would rise. It might easily rise to $6.00 or $7.00 (neither being linked to gold). If the price level rises in one country so that the purchasing power of bond interest and unaltered wages is reduced, and more of the price goes into profits than in the other country, it can afford to cut prices slightly in a foreign market and get more business without losing, but indeed, making that extra profit which comes to a larger volume at a slightly less nominal rate of profit. So that amount of extra inflation which depreciates the exchange against sterling is good for American foreign trade and bad for competing British trade, and hence comes the temptation for a race in exchange depreciation. But if it proceeds so that the foreigner distrusts the purchasing power of dollars to hold good, he will force the selling, never hold, clear out his deposits, and the exchange takes a nose dive for psychological reasons *quite unrelated to the comparison of price levels*. This has important effects we have no space to discuss here.

Now the foreign trade aspect of exchange stability between two currencies is most important to the country with the greatest dependence on foreign trade. It is almost certain that we could not expect that the American dollar price level would be doubled (American costs remaining the same) while the British sterling level remained constant, and the change be taken up in a new rate of exchange which produced this bad competitive result. We should certainly find that the British price level would rise too, so that the exchange rate would not need to change to so great an extent.

When the sterling dollar rate changed after Britain went off the gold standard it was because the American dollar price level was allowed to fall continuously with the greater value of gold, while the British sterling price level was not allowed to be further deflated, it was not for any conscious attempt to secure a foreign trade advantage—this is a derivative and not a cause.

Now the third relationship, which we tend not to think explicitly about, is that between *gold and commodities*. Until recently, gold has become steadily more valuable, gold prices have fallen, but we do not know how the gold relationship will behave in future. If you know the relation between the dollar and commodities, and that between gold and commodities, you can deduce the relation between gold and the dollar, that is, you know how much devaluation of the dollar in a return to the gold standard is necessary. If you know the relation between sterling and commodities, and gold and commodities, you know how much to devalue sterling in a return to the gold standard. The two results will give you automatically the par rate of sterling dollar exchange.

It is idle for America to discuss the amount of devaluation until they have determined what dollar price level they want for their domestic structure, estimated the gold price level and compared the two. It is idle to discuss the rate of exchange with them at which we shall go back to the gold standard until we know the amount of devaluation they must have. The two relations are inter-dependent, and dealing with one only gives results which must be rubbish to practical men.

The key to the situation for a permanent return to gold, on devalued levels, producing rates of exchange which are fair to foreign trade, and consistent with price levels that agree with industry and debts, is still therefore the behaviour of gold (and the credit systems based thereon) compared with commodities.

What will be the future value of gold? So long as we are discontented with non-gold currencies and regard gold as a safe haven to which we hope to return it will be important and desired. But if we get on well without it, and it has no monopoly of currency basis, and we evince no desire to return to it, it would rapidly become less valuable in relation to goods, gold prices would rise rapidly and pass the old parity of dollars and sterling, so that our currencies, instead of being devalued in terms of gold, would all be super-valued!

There is a great deal of unreasoning prejudice against the mere term *inflation*, because of past history which is in no way comparable. I should no more call the reflation which is now taking place from these ruinously and abnormally low price levels "*inflation*" than I should call a man a *mountaineer* when he is coming up from the cellar.

We must ignore for the present the disturbing question as to the ultimate movement and value of gold and assume that it is a constant factor. Then we must do everything we can, country by country, to prevent the currency unit engendering a depreciation on purely speculative lines. While a depreciating currency will do much in itself to introduce a movement of prices in sympathy, it may for a long time be parted from it and we should aim at keeping the Exchanges as near purchasing power parities as possible. It can at best be only empirical and approximate, but it is better than having no aim at all, and it is quite possible to let attempts to control the dollar go as an element in foreign trade, and to get equivalence between the other non-gold currencies and gold within broad zones for short periods. If it is stated to be the avowed object of a gold country at the present time not to let gold depreciate in value, nor the currency based upon it, then the immediate question we have to ask ourselves is: Are we satisfied that our present price level meets all our wishes and does justice to the requirements of our economic organism—in other words, can substantial profits be made? If not, then we must face up to the surgical operation of altering the exchange rate between sterling and those countries, otherwise the object of adjustment of our price level is defeated. It would perhaps be better to do this by modest stages, and not very perceptibly, than to wait until the movements of the dollar currency now left to itself

have become so striking as to cause considerable inconvenience to international trade and compel the movement of sterling, which in the endeavour to make an adjustment with the dollar in trade, would necessarily involve a very sudden break indeed with the gold currencies.

It is not the purpose of my paper really to discuss the day-to-day problem of the moment, but I am merely introducing this factor because people are sure to declare otherwise that the paper is too abstract and does not face up to current difficulties.

Let us touch the middle range of problems, viz, the return to the gold standard.

We are increasingly realising that monetary science can never be exactly laid down because it is a subtle compound of the quasi-mechanical and quantitative forces and equivalents of the pure quantity theory of money with an attitude of mind about money, and if that attitude changes, some of the principles will refuse to work. It is as though we constructed a machine with a propeller to work in water and then asked it to do its work in syrup or in air. All the quantitative relationships upon which we build a science depend on reasonable consistency in the reactions of economic men in groups to certain stimuli. We realise that nothing is either good or bad, but thinking makes it so, and that that system will be unsafe which people persist in thinking is unsafe. In short, the element of confidence is capable of much wider variation than we had thought and, taken beyond certain limits in either direction, it renders possible or impossible, as the case may be, the application of our principles. If people in the mass persist in thinking that certain monetary mechanism is not safe, they will certainly succeed in making it unsafe. In the field of currency mass psychology has its greatest scope for economic derangement. Although at bottom economic facts are the things that matter in the end, in the short run, what people think about economic facts, however mistakenly, is just as important as the fact itself. It may be a long time before they find out their mistake and gain confidence, and, in the meantime, their flight from one fancied horror will bring new horrors in its train.

The incomparable derangement in which we now find the world's monetary affairs, and the exceedingly difficult task before us of restoring the damage, and also making a new machine, which will not go wrong in the same ways as the old, call for a careful examination in every country of the particular ills to which it has fallen a prey; the particular hopes that it desires to preserve and the particular psychological difficulties that its history and traditions and policies make likely to persist in all the separate countries. What are finally emerging as the particular difficulties of the past in relation to monetary affairs? There have been many charges and counter charges —some of them from abroad, some from political rivalries within and some from a genuine conflict of economic ideals. Many of them depend upon different estimates of what human nature can stand and understand.

What, then, are the weaknesses that stand revealed so far as England is concerned? I should enumerate seven as being the most important or distinctive. First, London, by reason of its immense financial services to the Empire and the world, by its traditional leadership in the gold standard from the 19th century, and by the prevalence of the sterling bill, has been a too sensitive reservoir of world funds. This situation might have been different if any one person or institution had been conscious of the totality of the movements, but in the aggregate we have been ignorant of them. Even at a time of special investigation, when the Macmillan Committee on Finance and Industry was paying particular attention to the subject and collecting special *ad hoc* statistics, they failed to grasp the whole truth. In asking themselves the question "how sensitive is London to a sudden flight from sterling, either in distrust of London and sterling or because of difficulties in foreign monetary centres, making it necessary for them to repatriate their deposits," they ascertained the deposits in the London banks and came to the conclusion that London was reasonably secure on balance from foreign pressure, but they did not know and did not ascertain the deposits in the London branches of foreign institutions; nor was *anyone* really seized of the actual position in London; it had been no-one's business and it was not realised how increasingly sensitive this liability had become. If any market was to have as great a capacity for variation in range and as great a sensitiveness, then it could only do so with safety if the conditions were known, at any rate, to someone in control, if not publicly. But these vast aggregates were varying without the knowledge of any living soul; varying in hidden conditions in which disaster was a question only of degree. A *sine qua non* of the future, therefore, is that the Central Banks or the Governments should have some fairly approximate and frequent up-to-date knowledge of the total balance and "time quality" of indebtedness in its markets.

In the second place, the charge sometimes made by continental writers that the responsibility for working the gold standard throughout the industrial organism was not recognised must be admitted to be in part true. The gold standard certainly pre-supposes that the flow of gold to balance international trade must work out its effects in raising and lowering costs; otherwise, that standard is meaningless. The gold was flowing for political reasons and other reasons that were artificial compared with the balance of trade, and every effort was made to prevent wages and other costs rising and falling. The natural reactions of the gold standard were, therefore, denied—denied no doubt, or prevented, in self protection, but all the same having the effects of *prevention* in destroying the self-balancing qualities of the gold standard. England's reactions were too tardy and too limited, and the consequence was growing unemployment, due to the increasing level of real wages and the spiral of deflation. The lesson for the future is that gold ought not to flow for any other purpose than trade balancing, and that if it

does *not* then the responsibility for allowing it to have its natural effects upon the price level can be more readily accepted; but all the same it ought to be accepted. The social question, however, arises as to whether democratic institutions and governments will trust themselves to this mechanism, so sacred are the obsessions about the fixity of money wages and interest contracts.

In the third place, the flow of monetary savings or subtraction of purchasing power from current expenditure is too steady and unyielding in a country with a network of provident institutions, insurance societies, sinking funds and other irresistible streams which do not respond to the governing factor of price. If the change in the price of money has not the time-honoured economic effect of other changes of price in equating supply and demand, we are bound to get a condition of unstable equilibrium; and the phenomenon of savings being far in excess of investment, and bringing about an excess of current production over current consumption, and consequent unemployment, is one that is partly due to this insensitiveness. It cannot be said that we ought for the future to restrict the amount of savings in these compulsory directions, but we ought to find some way of making the investment market more sensitive and absorbing. This is mainly a problem of confidence and perhaps when the other factors are put right this new confidence will be a natural product.

The fourth aspect is allied to the foregoing excessive steadiness of the flow. It is that the connection between the capital uses of money and the supply of money for those uses is too remote and disjointed, it being impossible to retard or enlarge the flow, as the case may be, very quickly or sensitively, so that the next best thing is to cultivate the technique through public and private investments, acting in a complementary way to each other, of absorbing these funds; and here large questions of politics of governments are raised. Expenditure on public works, however useful for economic reasons, raises questions of politics and efficiency which may not be easily solved.

In the fifth place, a centre like London, which is looked upon to superintend and supply funds for foreign borrowers all over the world, can in the long run only supply what is left out of the total savings of the country after home capital is absorbed. If at any time these claims are greater than the home savings, difficulties are likely to arise.

Now the perfection of London as a lending market is a separately developed technique and it has no necessary connection, except so far as checked by underlying economic forces, with the total savings available at any time. It is possible for it to go on approving loans and issuing them, while its citizens have not really put themselves in a position to implement those loans out of their own resources. The underlying tendency then is for the funds to be drawn from foreign markets on short term, and we get a lack of equilibrium between the "time" quality of the money loaned and money borrowed, which some day is fraught with difficulty. Here again, a closer knowledge of economic conditions at home and abroad, and some central control over private lending houses, seems to emerge as desirable.

In the sixth place, if London lends abroad on a large scale, but the North of England, in its exporting industries, has costs too high for successful foreign exportation, then our industries will fail to implement what our financiers have promised to lend, for in the long run, financial loans must be implemented by industrial exports, except so far as they absorb foreign funds due to us. If our export costs are maintained, by trade union action or otherwise, on too high a level, then a great strain must be thrown upon the gold reserves or upon a good equilibrium between lending and borrowing. In the past no attempt has been made to link the amount of our London lending abroad with our power to export.

In the last place, with a rapidly falling price level, real wages have increased at too great a speed. The purchasing power has been transferred from the hands of ordinary shareholders and institutions, who might have used it for increasing investments abroad. It has got into the hands of millions with increased purchasing power, who have enjoyed their new-found command over foreign produce of all kinds. In this way it has become fatally easy to squeeze the favourable balance of trade into the standard of living and to increase the actual total quantity of goods purchased from abroad at a time when the actual capacity of a country to purchase, judged by its productive power, is falling rapidly. This was one of the reasons why the balance of trade went so heavily against Britain in 1929, 1930 and 1931. For the future, in order to avoid it, we can only say that prices ought not to be allowed to fall because they make constant money wages into a dangerously high real wage. But inasmuch as this is a pious wish, easier to enunciate than to achieve, we have to say the next best thing, viz, that if prices do fall and real wages do rise, there should be a greater measure of adjustment in the industrial machine to counteract it. This answer is also, under modern conditions, more or less visionary. Perhaps the next best thing is to impede the flow of goods from abroad by artificial means, duties, &c., in order that the balance of trade may be properly protected and real wages prevented from becoming too high. It is a hard doctrine, but the proper economic line here would be to make good some of the transfer between the ordinary shareholder and the receiver of relatively fixed incomes and wages by relieving the taxation on the former, enabling him to have more to save, and increasing the taxation on the latter, preventing him from straining the gold position, endangering the foreign loan market, and upsetting the whole economic organism by an excessive import of foreign foods and luxuries.

These seven fundamental causes are interlocked and interlaced. I have had Britain in mind throughout and I do not doubt that a similar survey of the strains and stresses in other countries will throw up

tendencies which are individual to each of them. It is only by agreement upon the same central principles and careful protection against our own idiosyncracies that we can hope to work the international machine.

The third problem of long-range possibility of a single measure of value domestically and internationally in a world that is neither *laissez faire*, nor controlled, is, I suppose, at the bottom, a political question. How far shall we cede national sovereignty in financial matters to international direction and control? Secondy, how far will political governments be stable enough to run currency questions without political bias, and third, how far will national psychologies enable us to eliminate great waves of expansion and depression? To cut across these large problems which will decide these broad questions of monetary measurement in the future, we have the more pertinent question: How far must the financial world be regulated and ruled by purely accountancy conceptions, which are, after all, only conventions and the very mention of which will put up all your bristles?

Accountancy is based firmly upon the understanding that money values are real and unvarying, and has no way of recognising the fact they are not. The conventions it adopts dominate banking and contracts and while a great protection against fraud and insecurity, are almost wholly vicious in their influence upon the amplitude of credit cycles, making booms and depressions more extreme than they need be. That results from a constant comparison of two kinds of asset, money and fixed money claims like mortgages and debentures and their interest, with the varying monetary expression of the values of physical assets, which are not *in pari materia*. When prices are rising, profits are higher because of the lag between the prices paid for the goods in the early part of the year and that realised by sale later, because of the lag in wages, because of the provision for wasting capital being only upon the old cost, and not upon the year's share of a renewal cost, because of the ease of repayment of fixed charges, because of the diminishing real value of assets held, or fixed money equivalents. When prices fall, real profits are similarly cramped, except for the convention about stock valuation and depreciation of securities. These exceptions create so-called secret reserves.

Now, if the price level were moving to a completely and permanent new level it would not much matter, but if it is fluctuating about a norm or level, the incentive to launch out and increase business when profits are increasing (not through increased trade, but changing prices) is unduly increased, and when profits are falling is unduly diminished. Prudent businesses do something to counteract this by making larger reserves in good times to be drawn on in bad, but that does not alter the effect of expansion or contraction as *incentives*.

If we are entitled to assume that every upward oscillation of price is going to entail one downwards of corresponding magnitude, then obviously we ought to perform that operation which accountants invented during the war, which was condemned by tax experts, and which was never effective in practice, viz, to divide profit into that part due to output on an unchanging price, and that part due to the change of price—leaving it assumed, I suppose, that any increase in output would have come about without the price increase and is entitled to be reckoned as profit not dependent on the impetus of price change, which is hardly true, though there is actually much less of such increase for all commodities taken together, on a price change, than might be supposed. Then we are entitled to regard the price-change-profit-section as only a suspense account to be held against the inevitable deficit. For on the falling market the true economic profit is greater than that shown, even for the smaller output, and the suspense account comes into action to make up the difference. The excess profit consists not merely in the difference in the price at which things can be bought *wholesale* on the day of sale compared with the actual price at which they were brought into stock, in a merchanting business, but also in a producing business in the excess of the price realisable over previous prices realised, assuming that costs have not equally advanced. It is not enough, economically, to hold these sums in reserve and *invest* them—they must be treated as a non-tangible asset, or of course in the balance sheet balanced by a book-keeping liability, though a more consistent plan would be to write down the assets themselves.

Now the non-distribution of a part of the proceeds of production during times of inflation has important economic consequences into which I will not enter. In the ordinary way, a reserve out of profits depletes purchasing power in the hands of the shareholding public, goes through the investment market and increases the supply of savings more directly, or increases stocks, and so demand for capital goods tends to be stimulated and that of commodities restricted, but on the whole, the total purchasing power is only reclassified and not reduced. In the case to which I refer, the reserve must be held idle. Two important anti-inflationary influences would, therefore, be at work: first, a psychological one on undue business expansion, and second, a physical one annihilating some of the purchasing power created or "tokened" by current production. A converse process would be set up on a fall in prices below normal. One could avoid all this if accountancy permitted fixed value assets to be written up and down, before computing profits, affecting profits by its appropriate annual equivalent, but this no doubt introduces counter considerations of individual security.

A further field in which the domination of accountancy conventions reverses the true direction of economic forces in changing values, with a wide repercussion on international finance, is the theory of the stock exchange price. We should ordinarily understand that Wall Street would register what is actually happening or likely to happen in the industrial world, providing a register of results, a thermometer

so to speak. Instead of that it is often an originating cause, instead of a record or an anticipation of what must be. A burst of bear speculation, or a wave of pessimism and selling we will say lowers the price of a particular stock some points. The banks, scrutinising their loans and collaterals, wish to satisfy their accountants' rule that loans should be covered, or proportionately so, and other conventions of soundness and liquidity, and, although nothing whatever has happened to the actual business itself to justify the change, they therefore automatically call in, reduce, or ask for more cover. The industrialist soon feels the effect—he finds his range of credit reduced, and decides to restrict his holding of stocks by selling low and buying less, or decides not to enter into some additional commitment he was contemplating. Deflation has set in, originated from the wrong end and working through an accountancy rule. The lowering of business activities then actually lowers a stock exchange price on merits, where it has been put without necessity.

The prudential rules of accountancy that in stocks and securities diminished values should be taken notice of, but increased values must not be considered, however good for individual security, are economically on a wide scale, disadvantageous. The theory that if A. holds government stock costing £10,000, and on its rise to £15,000 can no nothing about it if he still holds it, whereas B., having sold at £15,000 and re-invested that £15,000 in another stock which stands at £15,000, is entitled to use a capital profit of £5,000 *because it is realised*, is economically nonsense. Both A.'s original stock now held *worth* £15,000, and B.'s new stock (perhaps the same kind) *costing* £15,000, and showing no depreciation, are *equally liable* to reaction to £10,000. Some of the accountancy conventions on foreign exchange are not without influence on international finance.

In conclusion, I would urge upon my hearers that there are no cut and dried solutions either of the immediate or the long-range problems, for we have not yet made up our minds what kind of a world we really desire to live in, and the balance between the principles of the world as an economic unit, or as a series of fortuitous non-economic units, between congruity of aims in an international scheme and the joy of independence and running our own show even at an economic cost, has not begun to be settled. The settlement affects every financial solution in the international field.

Discussion on Sir Josiah Stamp's Paper.

Prof. T. E. GREGORY (Cassel Professor of Banking, University of London) said that he was afraid some of them were going to be disappointed. It was not going to be a case of David trying to slay Goliath because the issues were so multitudinous and vast there were points of agreement as well as points of difference between all economists. He was going to keep himself strictly within his time limit and there were four things he would like to refer to. The first of his points was that there was no agreement at the present time on first principles. That was very important to remember and very important to emphasize, because there was a natural impatience on the part of the public and on the part of business men that something should be done. But he ventured to suggest that it was highly dangerous in the interests of business itself if any premature solution were forced upon the world in order to satisfy mankind's natural impatience. It was quite true that there were no agreements between economists on many of the difficulties of the day. There was no agreement, for instance, with regard to the long period problem as to how they wanted prices really to behave. It was no use blaming economists for these things because they were bound to arise when one had very intricate matters to deal with, although it was proved that they knew certain of the practical advantages which followed from the adoption of certain measures. He agreed that it was no use just using the word "inflation" because there were many practical dangers when currency measures got out of hand as was shown when the upward movement of price levels had been allowed. America was trying an experiment which everyone would watch with the greatest interest from both the theoretical and practical point of view. There were enormous dangers in the experiment, and they did not know where it would lead them or the world. Economists had to confine themselves to practical common sense considerations which did point to the fact that reflationist experiments had shown in the past the dangers that arose as soon as currency was divorced from some metallic basis. However, he agreed with the principal speaker that they had no right to dispose of the American experiment as one which merely called for inflation, but they had the right to draw the attention of the public to the grave difficulties and dangers that might ensue in the course of that experiment being worked out. As to his second point, he agreed with Sir Josiah Stamp in his remarks with regard to the failure of adjustment between the level of costs and the level of prices. That was the cause of the depression and until some adjustment was made between the level of costs and the level of prices that depression could not lift. His point was that the degree of adjustment in different countries was very different and that difference was most marked if one took the extremes between this country and the United States. Among the great capitalistic countries, America had gone much further in adjusting prices to cost than had been the case in this country. Of the great industrial countries, we in this country were the most rigid and inelastic, whereas in America there had been remarkable mobility until the passing of the Industrial Recovery Act. One of the side issues was the introduction of what he called political inelasticity for its own sake, and he could not help thinking that the Industrial Recovery Act had come at an inappropriate time just when America was trying to raise the level of prices upon a very substantial level of cost. Whatever one might think, whether reflation or control, although they might not be compatible one with the other, they raised very great difficulties in the near future. His third point was one with which he thought accountants particularly should concern themselves in the very near future. Sir Josiah Stamp had drawn attention to the enormous importance of the control of international trade and of having a stable basis for international trade operations. However, he had failed to stress the enormous importance of stable currency, not forgetting the enormous importance of international investment. Sir Josiah Stamp had hinted that a state of affairs might become desirable where international investment in particular, and also domestic investment, ought to be the subject of some kind of Governmental control. There was one other aspect of that when discussing the international side of the problem. The raw material-producing countries must eventually industrialise themselves and the problem was where the capital was coming from that would be needed for the very material advance of both the raw material countries and the old investment countries. If they agreed with him, for the sake of argument, that international investments, whether on the old scale or on a new scale, did seem of first importance, then under present conditions of international currencies, international investments had become nothing except a gamble in the future value of currencies, which was a very bad state of affairs for the world to contemplate. It was undoubtedly true that the heavy trades of the

country depended upon the flow of international loans, and it was further undoubtedly true that the iron and steel trades of this country had been checked by the state of international investments three or four years ago. His fourth point was a very serious one. Even if they could adjust the level of costs to the level of prices with which the world was burdened they had to face the great mass of indebtedness the value of which was highly problematical. There existed no machinery by which the problem could be cleared up. The fundamental necessity for the recovery in world conditions was the creation of machinery by which the vast debts could be liquidated without delay and without unfairness either to the debtor or to the creditor. The question of the creation of such machinery had come under discussion at the World Economic Conference, but that Conference was not likely to remain in existence long enough to solve the problem. He therefore suggested that the international body of accountants present should consider the problem as of practical importance and as one that could only be solved by those who had experience in the liquidation of international debts. He was quite convinced that if they wished international investments to blossom again they must do away with the present frozen position. They must prevent prices falling, and to do that they must prevent such booms as ultimately caused them to fall. (Applause.)

Alderman CHARLES LATHAM, F.L.A.A., said that he quite agreed with Sir Josiah Stamp that it would be a good thing if they could ignore Stock Exchange valuations, and he wished they could convince their bank managers that such valuations should be ignored. Sir Josiah had stated that accountants were bound by convention, but surely in the case of loans against security they were bound by the requirements of the lender, and since the original price of the security had been the basis on which the loan was fixed then any movement in that quotation must be taken into account. He would like to put the point that securities should be valued on their permanent value according to the business and not fixed by an independent pool of investors. The suggestion that the whole of the assets of the company should be valued at the end of each financial year in order to obtain the real position raised very grave technical considerations for accountants and he hesitated to contemplate the position some accountants would find themselves in at the end of a year of trade depression if they had to revalue the whole of the assets of a company. He thought the reaction in the City upon such a proceeding would indeed be noticeable. It was difficult for a layman to discuss a paper such as they had listened to, especially having heard from Prof. Gregory that there was a wide field of divergence between Sir Josiah Stamp and Prof. Gregory himself. However, one of the main considerations was undoubtedly the immortality of the burden of a debt. Whatever asset might disappear, whatever asset might fall in value, the debt remained and the monetary expression of the burden increased with every increase in the depression, and any adjustment of costs to prices, urged by Prof. Gregory, simply served to increase the burden of those debts in so far as they were not liquidated or reduced. He would like to suggest that economists and accountants in this country and abroad were endeavouring to solve and adjust a world economic and financial situation by international monetary mechanism which was inappropriate to the problems that faced them. If they accepted such ideas, and such principles as might have been effective in the past in dealing with the conditions then existing, it was quite clear that the business man of the world, with the international financial monetary mechanism, was no longer able to deal with the situation because the world was faced with entirely new problems. It had been the dream of mankind, since he had adopted an upright position, to achieve abundance and to achieve freedom from insecurity, doubt and shortage, and immediately man's inventive capacity had produced an age of abundance they found they did not know how to deal with it, with the result that they were faced with an amazing situation. The world had been seeking abundance and now it was seeking to deal with the problem of how to get rid of abundance. If he might say so with the greatest respect, he thought they had been treating the economists with a good deal of toleration during the last three or four years, and he was not quite sure that the economists had requited that toleration in the way they should have done. They were not now seeking to deal with world economic problems because most of the world had now become actual industrialists or desired to become industrialists, and therefore the clever devices which they had seen in contemplation had to be scrapped and the problem had to be faced from the point of view of how to distribute the abundance that had been obtained. He therefore ventured to suggest that the adjusting of cost values to price values and such things of that kind sank into insignificance before that great problem. He welcomed the profound experiments that the President of the United States was now making in that direction, and he hoped and believed that if it was allowed to be worked out in its entirety it would make a signal contribution towards the solution of these problems.

Prof. JONES (University of Leeds) said that he would like to refer to the statement made by Prof. Gregory when he said that economists were not agreed upon first principles. He would like to suggest to him that there was a still more fundamental disagreement between economists than that, and that was the disagreement as to what constituted first principles. He had said, for example, that they were not agreed upon the way in which they desired prices to behave. Personally he was not in the least concerned how they behaved, as long as they did behave. One of the troubles at present was that prices misbehaved. He referred to that because in trying to place before the meeting the dilemmas that existed, in his opinion Prof. Gregory had only given the views of a small group of economists working at the London School. In the first place he had tried to convince them of the dangers of the present American policy of controlled reflation, but to his mind that was the same as trying to persuade a man to give up wines. If he indulged in them to excess it was to his advantage to be a moderate drinker, but in doing that one asked him to set up his own standard as to what constituted "moderate." One of the big problems to be faced by the world at the present time, and one in which accountants ought to be able to assist, was to equate the heavy burden of debts with the price levels now prevailing in the world. He suggested that the American method of controlled inflation, whether successful or not successful, was one method by which it was proposed to secure that desired equation, and if they did succeed in raising the world price level, not for the moment but for a long time to come, then they would, in effect, have gone a long way towards solving the burden of fixed debts in the various countries at the present time, because those fixed debts were expressed in money, and if they reduced the value of money they reduced the real burden of the debts. It seemed to him that the first principle with which Sir Josiah Stamp had dealt in his paper had been the principle of internationalism and the fundamental question which was before the world at the present time was whether they wished to divide up into small groups of nations, comparative strangers to each other, and pursue a policy of isolation and adopt different currencies wholly unrelated to each other, or try to restore the international spirit and organisation that had worked so successfully down to 1914. If he was right in his interpretation of the present paper and the earlier writings of Sir Josiah Stamp, it seemed to him that Sir Josiah was in favour of the restoration of internationalism in economic affairs. There he believed he was entirely right. If they believed it was worth while to try to build up the pre-war system, which was an international system, then they should try at the same time to restore its biggest influence, which was the gold standard. He was certain that it would be advantageous to restore the gold standard in spite of the difficulties of restoration because he believed that the gold standard as the instrument of internationalism in economic affairs was one of the best guarantees of peace in the world in future. The gold standard had been reasonably successful before the war broke out. Why had it failed during the last twelve or thirteen years? In the time at his disposal he could only

briefly indicate one or two of the differences of the pre-war world and the world during the last ten years. In that connection he ventured to suggest the importance of not conecntrating upon the affairs of the present year or the previous year as they were passing through a period of intense depression which had brought into operation forces which had not been generated earlier, and it was those forces that should occupy their attention. If they went back to pre-war days there was in operation at that time a gold standard which had been the result of slow growth, and because of the slowness of that growth the various nations had been able to adapt themselves to it. Prices had been adjusted to an international price level. When they had returned to gold after the war, they had rushed back to that standard without any prior examination of the differences that had crept in between the various nations. It had been a plunge in the dark and an extremely bad plunge. Price levels had been out of line, and when the gold standard was restored they had continued to be out of line with the result that it imposed a strain on the industrial structure, and the policy of maintaining the gold standard since 1925 in this country had self-imposed a strain on the industrial structure which it should not have been called upon to bear. It was not true to say that there had not been any fluctuations in the levels of wages comparable with those before the war. In fact, the fluctuations had been greater than at any time during the last 80 or 90 years. That was one of the big differences between the pre-war and the post-war period. There were other differences in relation to the industrial structure and long-term investment and the accumulation of short funds and so on, but he would merely like to stress one important fact which seemed to be misunderstood in the country at the present time. That was that the industrial structure of this country, the Trade Union structure, had not been such as to prevent that adjustment of wages and costs that would be required in the normal working of the gold standard. (Applause.)

Mr. C. H. GOODING, F.L.A.A., said that he wanted to direct their attention a little bit to something the other speakers had not emphasised, namely, the psychological side of the problem. He thought that was of great importance because, if they were to take the long range problem to which Sir Josiah Stamp had referred, then they had got to get another type of people to attend their conferences, and he only wished that those people had been the representatives at the Conference that had been sitting in another place. They were not likely to receive consideration of these long range problems or even the short range problems from those responsible Ministers now in power. His point was that they were sending the wrong people to their conferences, and in his opinion it was the great economists of all nations who were the people to guide them in the right direction.

Mr. E. CASSLETON ELLIOTT, F.S.A.A., said that, in thanking Sir Josiah Stamp for his interesting paper, he would like to express his thanks to him and the other leading economists with them that day for their services to mankind. He thought they would find that newspapers were fond of chaffing economists, but their services were very useful perhaps chiefly because their sole intention was to do the greatest good for the greatest number of people. Economists might differ in certain of their views, but he was quite satisfied that their one aim was the betterment of mankind. He would like to refer for a few moments to the last portion of the paper which interested them as accountants. Sir Josiah Stamp said that accountants were hide-bound by convention. That was true. The only yardstick that had been mentioned was boots and he failed to see why boots were mentioned, but if they wanted to exchange their boots for a cow—which had also been mentioned—they would want a unit of how many pairs of boots were worth one cow. What better unit could they have than the one that had been in use for so many centuries? So far as the writing up and down of fixed assets was concerned, as accountants and auditors their troubles were quite sufficient as they were, and he thought they would all agree that if they had to revalue the fixed assets every time they drew up a balance sheet their position would be intolerable. Shareholders, too, would be misled, and nobody would know exactly where they were. He regarded accountancy as a precise science because if it was not a precise science he failed to see what use accountants were. He would like to make one final point with regard to the excessive profits made when prices were rising. As prudent accountants they always suggested, when excessive profits were made, and they so advised their directors when asked, that a substantial portion should be placed to reserve for future times of adversity. He was afraid they were not quite so consistent when the adverse times came along. They then thought it was better to retain that reserve in case later on even worse times should be experienced. They sometimes found themselves not in agreement with their directors under such circumstances. However, their advice was for the benefit of the business. They were very grateful to the three economists who had addressed them and appreciated what they said. He was quite satisfied in his own mind that they were here for the benefit of mankind and not for their own benefit, but were seeking to do something in this world of plenty to see how that plenty could be divided amongst the populations of the world. (Applause.)

Sir Josiah Stamp's Reply.

Sir JOSIAH STAMP, in reply, said that he had listened to the contributions to the discussion with very great interest, but would only refer to one or two of the points which had been raised. It was quite true, as Prof. Gregory had stated, that in certain ultimate questions there was considerable divergence of view, such questions as to how we wished prices to behave in future and also how we could flatten the trade cycle. The differences seemed to be very small indeed with reference to the principles underlying the paper. They were all trying to find a solution to the present problems, but they could not say which was the best system to adopt because they had to judge men in unknown conditions. However, the job of the economist was really to try to see the consequences of certain actions and the trouble was that to-day the business world was behaving in such an inconsequential manner that it was impossible for the economists to say what would happen. If the business world was going to behave in that way, they should not turn round on the economists and say they should have told them what would happen. He need only refer to the enormous divergence of views amongst many business men in the United States at the present moment to illustrate what he meant. With regard to Alderman Latham, he had said that the real problem was to find a way to distribute the world's abundance, but really he was only calling the same problem by another name. In his paper he had said that he wanted to get prices into relation with costs and he only wanted to do that so that they could distribute goods. The same thing applied to Alderman Latham's reference to economic security. There again he was calling the same thing by another name, and it was possible to be so secure that one could not move. Another speaker had told them that accountancy was a precise science, but they were trying to be exact with one element fixed and the other element moving all over the place. He was only asking accountants to be more precise and not less precise, but he wanted a new kind of precision and no one could say but that the effect of their conventions was tending to increase trade depression. When Noah left the Ark he told all the animals to come out and "be fruitful and multiply." All did accept two small snakes, and when he asked them why, they said, "We can't, we're adders"!

An expression of appreciation to Sir Josiah Stamp for his paper, and to the other speakers, was voiced by the Chairman.

A Paper was then read on

EXCHANGE FLUCTUATIONS IN RELATION TO ACCOUNTING AS REGARDS OPERATING RESULTS AND ASSET VALUES.

BY

Mr. A. E. CUTFORTH, C.B.E., F.C.A.

Mr. E. VAN DIEN (Holland) occupied the chair.

Mr. CUTFORTH said :—

There are few items of public information which remind us more vividly or more frequently of the economic vicissitudes to which the various countries of the world are subject from time to time than the quoted rates of exchange—in other words, the relative values of the currencies of the different countries.

The disadvantages of a currency not fixed by some more or less universal standard, such as that of gold, have always been recognised by students of economics and also by financiers, traders and others who are brought into frequent touch with the practical aspects of the question.

For a number of years prior to the great war the general tendency was towards the stabilisation of the exchanges ; and it seemed likely that at no very distant time the currencies of nearly all the civilised nations of the world would to all intents and purposes become fixed as between each other ; in other words, that the variations would be so slight as to cause little or no inconvenience to the flow of international trade and incidentally to present no difficulties to the accountant.

Effect of the Great War on Currencies.

The outbreak of the European war profoundly altered this situation. Financial transactions between enemies immediately ceased. As regards other channels of trade and finance, some were stimulated, some were diverted, and others were destroyed altogether. The belligerent nations borrowed money to the best of their ability, firstly from their own nationals, and then, so far as they were in a position to do so, from other nations. The money so borrowed may be said to have been blown into the air, destroying lives and property in the process. Small wonder was it, therefore, when at last the struggle came to an end, that the exchanges were in a chaotic condition. Nor was it easy to create new standards with any firm expectation that they would prove permanent. The unsolved problems of the settlement of inter-ally debts and of reparations, with their repercussion not merely upon the finances of the nations concerned, but upon the trading operations of their peoples with each other and with third parties, obscured the horizon. Added to this, political disturbances hindered, in many countries, the return to ordered progress.

And to-day, nearly fifteen years after the cessation of hostilities, there seems little prospect of the currencies of the chief countries of the world being stabilised in their relation to each other in the near future. Accountants therefore must be prepared for some long time to come to record or to verify from accounting records transactions taking place in fluctuating currencies.

Assumption in Regard to the Currency in which Balance Sheets and Profit and Loss Accounts are Submitted.

The first axiom which will, I suppose, be universally admitted is that the statements of account showing the position of any business, *i.e.*, the balance sheet and the revenue account or profit and loss account, must be presented in terms of the currency of the country where the owners of that business are domiciled. For example, a public corporation in the United States of America may own a number of public utility undertakings in South America. The detailed records of these various enterprises, kept in South America, will, of course, appear in the local books of account in the currencies of the countries where such enterprises are situated, as the local transactions take place in those currencies. But the annual balance sheets and profit and loss accounts which would require to be furnished to the shareholders in the United States of America, if presented in terms of, say, Brazilian milreis or Argentine pesos, would probably be unintelligible to the proprietors who received them, or, what is worse, misleading. It therefore follows that while the transactions in foreign countries—and the term "foreign" is used as meaning countries other than that where the owners of a business are domiciled —have to be recorded in the local currency in which they take place, the system of accountancy must be such as will enable a proper picture, showing the state of the affairs of the business, to be presented at regular intervals in terms of the currency of the home country.

As has been noted, the owner of a business naturally looks at transactions in the light of the currency of his own country. In other words, he instinctively tries to convert, in his mind, transactions in a foreign currency to their equivalent in terms of the currency of his own country. Such a man is therefore apt to regard the currency of his own country as being the stable currency and the currencies of foreign countries with which he does business as fluctuating currencies. Great Britain departed from the gold standard in the autumn of 1931, and the United States of America departed from the gold standard in the spring of this year, 1933. In 1932, therefore, the currency of the United States was fixed in relation to gold, whereas the currency of Great Britain was a fluctuating one. But the Englishman in 1932 would still require the accounts of businesses in which he is interested to be presented in terms of sterling, and would take no cognisance of the fact that the pound sterling was no longer linked to gold. An English farmer, with a predilection towards keeping a reserve of cash in his house, may have had stored away in 1930 fifty golden sovereigns. Early in 1931 he may have expended thirty of these on the purchase of a cow. The remaining twenty were only brought from their hiding place in 1932, when they were required for the purchase of another cow. The farmer knew that these twenty sovereigns no longer

formed part of the currency of his country, but that he could sell them to a dealer in gold in exchange for currency. He did so, and they realised, let it be assumed, £26, with which he bought another cow. What have his two cows cost him? Before he bought his first cow he possessed currency (represented at that time by golden sovereigns) amounting to £50. After he had completed in 1932 the purchase of his second cow he had exhausted his funds and had in their place two cows. If he thought in terms of gold he would say that his two cows had cost him £50. But if he thinks—as the ordinary man would do—in terms of currency, he would say that his two cows had cost him £56, and that the excess of this sum over the £50 which he had in 1930, namely, £6, represented a profit on the realisation of the twenty gold sovereigns in 1932. His books of account have certainly to be kept in terms of the currency of his country; and they should therefore record the first cow as having cost him £30 and the second cow £26.

Assumption that Accounting Records are concerned with at least Two Currencies.

It is, perhaps, unnecessary to mention that when one is referring to the treatment of fluctuating currency in accounts, one has not in mind the cases where the transactions are taking place and the accounts are kept wholly in one country, although such country's currency may be a fluctuating one when measured by a gold standard. One is considering the case of where two or more countries are concerned, and where the values of the currencies fluctuate in relation to each other. And, for the reasons already given, one has to proceed on the assumption that the currency of the country in which the owners of the business are domiciled is, for book-keeping purposes, to be deemed to be the fixed currency, and the currencies of the other countries with which or in which transactions are taking place as the fluctuating currencies.

II.—Main Principles of Currency Conversions for Purposes of the Balance Sheet and the Profit and Loss Account.

Textbooks which deal with the treatment of a fluctuating currency in accounts lay down the following four main principles in regard to the preparation of a balance sheet and a profit and loss account in terms of a fixed currency:—

(i) That capital expenditure, incurred in fluctuating currency, should be converted into the fixed currency at the rate of exchange prevailing when the expenditure was incurred.

(ii) That floating assets (other than stocks) and liabilities in the fluctuating currency should be converted into the fixed currency at the rate of exchange prevailing on the date as at which the balance sheet is drawn up.

(iii) That stocks of goods in hand at the date of the balance sheet, which have been purchased in the fluctuating currency, should be converted into the fixed currency at the rates of exchange prevailing at the times when they were acquired. Goods purchased for re-sale should be written down to market value if such is less than their cost.

(iv) That profits earned in a fluctuating currency must be converted into fixed currency at the average rate of exchange prevailing during the time when the profits were earned. The same principle would, of course, apply in regard to losses.

As will be appreciated, a number of points of interest and importance arise in practice in the application of the foregoing principles; and it will be convenient to group them under the four heads set out above.

III.—Capital Expenditure.

Firstly, then, there can be considered questions incidental to the recording of capital expenditure.

Composition of Capital Expenditure.

Speaking in general terms, capital expenditure may be said to be composed firstly of wages, secondly of materials, and thirdly of a number of administrative and other charges incurred on capital account. One is speaking, of course, of cases where a business or undertaking carries out its own capital expenditure, and not of cases where the expenditure is placed in the hands of a contractor, or of cases where fixed assets are bought in a complete state, as, for example, a works or a factory.

Wages paid on Capital Account.

For the purpose of ascertaining the equivalent, in terms of the fixed currency, of the wages paid in the fluctuating currency on capital account, it is the usual practice to convert the monthly totals of the wages at the average of the daily rates of exchange prevailing during the month, or in cases where the fluctuating currency does not vary very greatly in value, to convert the totals quarterly, half-yearly or yearly. The choice between dealing with the totals at short or at longer intervals depends firstly on the extent of the variations in the value of the currency, and secondly on the question of whether the capital expenditure is being incurred more or less evenly over a financial period or whether it is much heavier in some months than in others. In case of doubt, it is preferable to choose the shorter periods, as this procedure, while entailing a little more work and trouble, certainly yields the more accurate results. One may take as an example the case of an English company owning a railway system in the Argentine Republic. During a particular financial year the average rate of exchange, let it be assumed, has been such that twelve Argentine paper pesos have been equivalent to £1 sterling. A capital expenditure programme has been in progress throughout the year, and the total capital expenditure on wages during the year has amounted to 6,000 pesos. The conversion of 6,000 pesos into sterling at the rate of 12 pesos to the £ gives a sterling equivalent of £500. But on closer examination it is ascertained, firstly, that of the 6,000 pesos, no less than 5,000 were expended during the first month of

the year, and also that during that month 10 pesos were worth £1 sterling. Obviously, there should be attributed to these 5,000 pesos a rate of 10 pesos to the £, instead of the average rate of the year. Five thousand pesos at the rate of 10 pesos to the £ equal £500, while at the rate of 12 pesos to the £ they only equal about £417. The basis of applying to the 5,000 pesos the average rate of exchange applicable to the year would therefore result in the capital account being undercharged by about £83; and the case clearly calls for the conversion of monthly totals at the average monthly rates of exchange. It will, of course, be realised that the conversion of the totals of even so short a period as a month at the average monthly rate of exchange does not achieve absolute accuracy. If absolute accuracy were sought to be secured, then presumably the conversion of the wages applicable to each day should be made at the rate of exchange of that day. But the accountancy system is the servant and not the master of a business, and no accountant would go so far as to suggest that the extra work involved in the daily conversions was a reasonable price to pay for the extra degree of accuracy obtained.

As will be explained later, the application of inappropriate rates of exchange for the purpose of making conversions from one currency to another for bookkeeping purposes does not always perpetuate an error; the error may be automatically adjusted in the same or in the next financial period. This does not, however, apply where capital expenditure is concerned. An over debit, or an under debit to a capital expenditure account creates an incorrect figure which remains on the books in perpetuity —except, of course, to the extent to which it may gradually be reduced from year to year by the writing off of depreciation or be removed by the sale of the asset. It will be appreciated also that an overcharge or undercharge to capital account automatically entails an overstatement or an understatement of profits.

Occasionally, specious arguments are put forward, in perfectly good faith, in support of a departure, in certain circumstances, from the generally accepted principle in regard to the conversion of capital expenditure. For example, the Argentine currency was at one time, practically speaking, fixed in relation to English currency on a basis which gave to the Argentine paper peso a value of about 1s. 9d. The subsequent decline in value of the Argentine currency (the rate in February, 1933, was about 1s. 6d.) did not cause a proportionate rise in prices in the Argentine expressed in Argentine pesos. For the purposes of this illustration, let it be assumed that there had been no rise at all in the rates of wages in the Argentine, expressed in Argentine pesos. An English company may have been engaged on a capital expenditure programme necessitating the disbursement of a considerable sum in local wages, and this work may have been in progress during the time when the Argentine exchange began to fall. The directors of such a company may conceivably say to themselves: "For every 100 pesos which are being spent on labour, just as much work is being done as was the case before the Argentine currency fell in value in relation to sterling. For a number of years past we have converted the Argentine currency into sterling for the purpose of our capital expenditure and other accounts at the par rate of exchange. When judged by that standard, the capital expenditure incurred in currency is still worth par to us, and we propose to continue to convert it at par." A little reflection will show the fallacy of such an argument. In the first place, capital expenditure is not recorded in books of account at what the parties interested may think is its real value to them; it is recorded on the basis of what it actually cost. In the case under consideration, the expenditure incurred when the Argentine peso fell in value became, when expressed in sterling, correspondingly lighter. The same number of pesos may, it is true, have purchased the same amount of labour as before, but from the standpoint of sterling the cost was less. In the second place, the pesos so spent were in liquid form: not improbably they formed part of a currency bank balance. Had they still been in that state when the balance sheet was prepared, they would have been valued, in common with other currency floating assets, on the basis of the rate of exchange prevalent at that date; that is to say, at a rate considerably under par. The fact that they have been converted from a floating asset into a fixed asset, namely, from cash at bankers to capital expenditure, is no justification for attributing to them any higher sterling equivalent than the equivalent at the time when they were spent. Indeed, to attribute such higher value to them is tantamount, as has already been mentioned, to overstating profits: in other words, an overcharge to capital account involves an undercharge or an overcredit to revenue account.

Profits and Losses on Currency Floating Assets and Liabilities Incidental to Capital Expenditure.

Difficult questions sometimes arise in connection with exchange profits and losses on currency floating assets and liabilities which are incidental to a capital expenditure programme. There is, firstly, the question of principle, that is to say, whether such exchange profits or losses should be credited or debited to capital account, or whether they should be taken to profit and loss account.

For example, it occasionally happens that considerable liquid resources are specially accumulated in the fluctuating currency preparatory to being spent on capital account. These funds, which are probably represented by cash at bankers, increase or decline in value as the rate of exchange fluctuates; and it may be that they are of considerably less value at the time when they are expended than at the time when they were first accumulated. It would seem reasonable, in view of the fact that these liquid resources did not form any part of the floating capital necessary for the carrying on of the business or undertaking—that is to say, for its maintenance or operation—but were definitely earmarked for capital purposes, that any loss occurring owing to a decline

in the rate of exchange between the time when they were accumulated and the time when they were expended, should be debited to capital account as being incidental to the capital expenditure programme and in no way connected with the revenue account. On the other hand, those responsible for the preparation of the periodical accounts of such a business or undertaking might well decide that in spite of the justification for the charging of such a loss to capital account, it would be preferable as a measure of financial prudence, to write it off to revenue account, in order that the charges to capital account may be limited to the actual cost of the fixed assets acquired or constructed, and shall not contain any losses of floating capital, although such losses may be incidental to the capital expenditure programme, and quite unconnected with revenue.

In considering the above question, it is of interest to bear in mind the legal interpretation of "profits available for dividend." One is speaking now, of course, of the position from the point of view of the law of England. The legislature has carefully avoided attempting to define "profits" and those of us who, as practising accountants, are brought almost daily into touch with the practical aspects of the question, realise that a satisfactory definition is an impossibility. In specific cases, however, which have come before the English courts for decision, certain principles have been indicated by the judges: and one of these principles is to the effect that in arriving at profits available for dividend, losses of floating or circulating capital must be made good, but that losses of fixed capital need not necessarily be made good. So far as its form is concerned, cash accumulated at bankers with a view to its subsequent expenditure on capital account is clearly floating capital. But it is not floating capital in the sense that it is necessary for the ordinary carrying on of the business and is being used for that purpose. It appears to the writer, therefore, that the dicta of the judges referred to above cannot be regarded as implying that, under all circumstances, exchange losses on floating capital which is destined to be converted into fixed capital must be written off to profit and loss account.

It seems difficult to say more than that:—

(*a*) Each case must be judged on its own merits;

(*b*) In cases where the arguments both pro and con seem to be equally strong, it is well to err on the safe side. That is to say, that if there is a loss it should be written off to revenue account, and if a profit it should be taken to the credit of capital account; and

(*c*) If a loss on exchange is debited to capital account this should be shown separately in any statement of accounts and not included as part of the actual cost of the fixed assets: similarly, a credit to capital account should be shown separately.

As will be appreciated, there is an alternative course in appropriate cases which, in a sense, combines the two methods of treatment, and that is to hold up the loss in suspense on the assets side of the balance sheet temporarily and then to write it off to profit and loss account over a series of years.

A not altogether dissimilar situation, in principle, arises where, in order to pay for capital expenditure incurred in a country whose currency fluctuates, a loan is raised from a bank in that country. If, subsequent to the time when the loan is raised, the currency appreciates in value, there is a corresponding increase in the amount of the liability; and as the liability had been expressly incurred for capital purposes, it might be argued that instead of the loss arising from the increase in this liability being written off to profit and loss account, it should be charged to capital account as being incidental to the capital expenditure. It is submitted, however, that this principle is not one which would find acceptance among accountants.

A case arose not long ago where a company domiciled in England but engaged in business in the Union of South Africa, raised a loan (of a permanent nature) in South Africa, and purchased premises with the proceeds. At that time the currencies of both England and South Africa were on the gold basis, and therefore the South African pound was considered as being equivalent to the English pound. Consequently, in the balance sheet (exhibited in England) the transaction (using hypothetical figures) appeared thus:—

Loan account	£100,000	Cost of premises ..	£100,000

When, however, Great Britain departed from the gold standard, but the Union of South Africa still adhered to the gold standard, the English pound could no longer be treated as equivalent to the South African pound. In fact, four South African pounds became worth about five English pounds.

Consequently, when the next balance sheet required to be prepared in England, expressed in sterling, it appeared as follows:—

Loan account	£125,000	Cost of premises ..	£100,000
		Loss on exchange in connection with loan of £100,000 in South African pounds ..	25,000
	£125,000		£125,000

The above is an instance of where a loss on exchange arose in connection with the acquisition of a fixed asset, and had nothing whatever to do with the ordinary operating results of the business: yet no accountant, it is suggested, would be found to declare that the loss was one which could be carried to capital account.

Another argument which is occasionally heard in support of the capitalisation of a loss incurred on floating capital in circumstances similar to those

outlined is that, if the owners of the undertaking had not carried out the capital expenditure programme themselves, but had made an arrangement for a contractor to undertake it at a fixed price, that contractor would probably have had to provide liquid funds in the fluctuating currency somewhat in advance of the time when he required to spend them, or, alternatively, that he would have had to incur liabilities in the fluctuating currency; and that in view of the possible losses which he might conceivably have to incur by reason of variations in the rates of exchange, he would increase his contract price. In such an event the owners of the undertaking would have charged the whole contract price to capital account, although it would have included a reserve for possible losses on exchange, and also presumably an amount representing the contractor's profit. The answer to such an argument, of course, is that the books must deal with the transactions in the form in which they actually occurred; and that the fact that under different circumstances capital would have been charged with a larger sum and revenue relieved of a certain amount of loss has no bearing on the matter whatever.

Quite apart, however, from the difficulties of laying down a fixed principle, there are frequently difficulties in the application of a principle. In the examples quoted above, it is easy to earmark a loss as being incidental to capital expenditure; but in other cases in actual practice it may be quite difficult to earmark, beyond dispute, a loss as being attributable to capital. And this practical difficulty strengthens the argument, in such instances, for writing the loss off to revenue account.

Materials Used for Capital Purposes.

In so far as capital expenditure is composed of the use of materials, these may consist of materials purchased in the fluctuating currency of the country where the capital expenditure programme is being carried out or of materials imported from the country having the fixed currency. As regards the stores purchased locally, it is essential to ascertain the value of these, expressed in terms of the fixed currency, at the time when they were purchased, for such value expresses their cost, and it is at their cost price that they require to be embodied in the capital expenditure account in the books. Further reference will be made to the question of stores in general later. As regards stores purchased in the fixed currency, no such difficulty arises.

Miscellaneous Expenses Incurred in Currency on Capital Account.

With respect to items other than wages and materials which can enter into the composition of capital expenditure, it is, perhaps, unnecessary to make any comments except to mention that so far as the charges represent expenditure in the fluctuating currency, they require to be converted into the fixed currency at the rate of exchange prevailing at the time when the expenditure was incurred. In actual practice this may be achieved by dealing with totals monthly, quarterly, half-yearly or yearly, as may be appropriate, and converting these totals at the average rate of exchange of the month, quarter, half-year or year.

Capital Expenditure Usually Transferred to Head Office Books.

Before leaving the subject of capital expenditure, it should be mentioned that it is usually found most convenient, in the case of a business owned and controlled by parties in one country, but operating in a country where the currency fluctuates, to transfer the capital expenditure accounts from the local books to the head office books, in which latter books the expenditure is, of course, recorded in the currency of the country where the ownership and control exists. The reason for this is that such expenditure is not subsequently affected by any fluctuations in the exchange. As and when, in the course of each financial year, new capital expenditure is incurred, or any fixed assets are sold or scrapped, the necessary information is furnished by the local office to enable the appropriate entries to be made in the books of the head office where the capital expenditure accounts are recorded.

Provision for Depreciation or Replacement of Fixed Assets.

Special points of importance sometimes arise in connection with the provision for depreciation of fixed assets which are in use in the country having the fluctuating currency.

It is to be noted that just as the fixed asset accounts are recorded in terms of the fixed currency, the reserves for depreciation of such assets require to be dealt with in a similar manner. For example, let it be assumed that a fixed asset, say some machinery, was purchased for 100,000 Argentine paper pesos, and that it was thought necessary to make such a provision for depreciation as would amortise the cost of the asset in 20 years. It might seem at first sight as if this result could be achieved by debiting to profit and loss account each year for 20 years a sum of 5,000 Argentine paper pesos. Let it be presumed that at the time when the expenditure was incurred, the Argentine peso was worth 1s. 9d. The sterling equivalent of the expenditure would be £8,750. If during the 20 years the Argentine peso stood on average at the rate of 1s. 6d., it is clear that the depreciation reserve account, accumulated during the 20 years, would only amount at the end of that time to £7,500; in other words, it would be insufficient to amortise the cost of the asset at the end of its assumed economic life. It will therefore be realised that in order to maintain the depreciation fund on a proper basis, it will be necessary to charge, in arriving at the local profits of the business in each of the 20 years, such a number of Argentine pesos as at the average rate of exchange prevailing during such year gives a sterling equivalent of £437 10s.

The following matter may also be of importance in connection with provision for depreciation or renewal of fixed assets.

In most classes of undertaking, it is customary to provide such a sum for depreciation as will write off the cost of a fixed asset by the time that the economic life of such asset has expired. Then, when another

asset is purchased to take its place, the cost of the new asset is charged to capital account. The new asset, let it be presumed, is identical with the old; but it may cost less than the old asset originally cost, or it may cost more, as price levels may have changed considerably since the time when the old asset was acquired.

In some classes of undertaking, however, particularly in what are known as public utility undertakings, such as railways, it is customary to allow the cost of the fixed assets acquired or constructed to remain permanently on the capital account and not to write off any depreciation; but to build up, by charges in the annual revenue account, a renewal fund, and then, when the asset wears out and requires to be replaced by another similar asset, to charge the cost of the new asset against the renewal fund, irrespective of whether the new asset costs less or costs more than the asset which it has replaced. In deciding, therefore, what annual sums are necessary to be charged to profit and loss account and to be credited to the renewal fund in order that the renewal fund may be adequate for the purposes for which it was created, it is necessary to have regard to the probable cost of replacing the existing assets and not to the cost of the assets which are to be replaced. This aspect of the matter may be of considerable importance if the expenditure upon the original asset and also the expenditure necessary in order to renew that asset are in a currency which has fluctuated considerably in the past and may conceivably fluctuate considerably in the future. For example, a railway undertaking will have in its capital account the original cost of the rails, sleepers, &c., comprising its permanent way (*i.e.*, its track) and such cost will include the labour costs of laying the rails and sleepers. These labour costs will be paid in the currency of the country; and, if the currency of that country is subject to wide fluctuations, it may well be the case that the daily pay of a labourer engaged in the work of taking up old rails and sleepers and putting down new ones in their place, when converted into terms of the fixed currency (as would be necessary for accountancy purposes), is very different at the time when the renewing takes place from what it was when the rails and sleepers were originally laid down. If such is the case, it may be necessary to modify the annual sums debited to revenue account and credited to the renewals fund in order to meet the anticipated costs of replacement.

While referring to provisions for depreciation, whether created in order to write down the original cost of the assets or whether carried to a renewal fund to provide for the cost of renewing the asset, it should be mentioned that it is usually found most convenient to keep any balances on these accounts in the main books of the business or undertaking, that is to say, the books kept in the country where the owners of the concern are domiciled, and not to leave them in the local books. As already mentioned, this will involve their being recorded in terms of the fixed currency, and not retained as balances on the local books in terms of the fluctuating currency. The reasons for such a course being desirable will be obvious: the provisions for depreciation have been built up year by year by charges in the annual profit and loss accounts or revenue accounts in the fluctuating currency in the local books. As the local currency has a different real value each year, it is clear that the aggregation, over a long series of years, of these annual currency charges would be meaningless. It is necessary to stabilise the annual totals by converting them into terms of the fixed currency.

IV.—Currency Floating Assets and Liabilities.

Dealing now with the question of currency floating assets and liabilities, the principle on which these should be converted, for balance sheet purposes, from the fluctuating to the fixed currency, is that of applying the rate of exchange prevailing at the date of the balance sheet.

As will be inferred from what has been stated earlier, the term "currency floating assets" as used in this connection is not intended to include stores purchased in currency, as these do not require to be valued in terms of the fixed currency by applying the rate of exchange prevailing at the date of the balance sheet. They must be valued at the rate in force at the time when they were purchased—in other words, at the equivalent of their *cost*. This principle is, however, subject to the qualification, in regard to goods purchased for re-sale, that they must be written down to their market value at the date of the balance sheet, if such value is less than their cost.

As a rule currency floating assets consist mainly of book debts and of cash balances at bankers and in hand; and currency liabilities include creditors for supplies and for accrued salaries and wages, and reserves for outstanding expenses payable in the fluctuating currency.

It will be appreciated that if the currency floating assets exceed the currency liabilities, then a fall in the value of the fluctuating currency means a decline in the value attributed to the assets less the liabilities; in other words, there is a loss to be provided for. Conversely, if the currency liabilities exceed the currency floating assets, then a fall in the value of the fluctuating currency causes a profit to emerge on the books.

Unrealised Losses on Currency Floating Assets.

Occasionally the suggestion is put forward that it is unnecessary for a loss on exchange in connection with currency floating assets less liabilities to be computed and provided for until such loss is realised, as will be the case when the currency book debts, &c., have been liquidated, the currency liabilities paid off, and the balance remaining has been remitted and so converted into the fixed currency. In support of this argument it is submitted that the currency floating assets, less liabilities, represent permanent liquid capital for the local needs of the business; that when that capital was first provided there was no depreciation in the local currency; and that,

although the book debts are in constant process of realisation in cash, and the cash is in constant process of being used to discharge local liabilities, the balance being remitted home, yet other book debts, other cash balances and other liabilities are concurrently being created. "Why not, therefore," say the supporters of this argument, "allow this floating capital which is permanently necessary for the needs of the business, to be valued at the old par rate? As and when remittances occur, the profits or losses on these will be brought automatically into the accounts. Is not this sufficient, bearing in mind that unless the business is to be closed down, the necessary floating capital will never be remitted?"

This doctrine, according to the canons of good accounting, is unsound. The currency floating assets, less liabilities, represent circulating and not fixed capital; and in a balance sheet expressed in terms of a fixed currency, the floating capital cannot be said to be intact if it is included at a figure in excess of its real value on the date of the balance sheet. It is true that the loss owing to the depreciation of the local currency is an unrealised loss at the date of the balance sheet, but the loss is nevertheless a real one, and must be provided for.

Another suggestion which is sometimes encountered concerns a case where, at the date of a balance sheet there is shown to be a loss on the revaluation of the currency floating assets less liabilities, but where subsequent to the date of the balance sheet there was an improvement in the rate of exchange in consequence of which the loss was subsequently made good. It is argued that in such a case there is no need to provide for the loss. It is conceded, of course, that if, under circumstances such as these, the unrealised loss at the date of the balance sheet is provided for, a corresponding profit automatically emerges in the next financial period. It is submitted, however, that there is no logical justification for setting the one off against the other. The loss is, in fact, a loss attributable to the old accounting period, that is to say, the period to the date of the balance sheet, whereas the profit is a profit properly attributable to the new accounting period, *i.e.*, the period subsequent to the date of the balance sheet.

It will be appreciated that the principle laid down involves as a corollary that if, at the date of a balance sheet there is no loss arising on the re-valuation of the floating assets, less liabilities, but it can be clearly shown that, owing to a fall in exchange subsequent to that date, the floating assets ultimately realised less than the valuation figure, there is, nevertheless, no need to provide for such loss in preparing the balance sheet. This is admitted: the loss is the loss attributable to the new financial period and not to the old. In an extreme case, however, it may be deemed advisable as a measure of financial prudence, to make some reserve as at the date of the balance sheet, to provide for such a loss. It is, for example, conceivable that in the absence of the creation of such a reserve, the shareholders in a limited liability company might consider that the company's liquid resources permitted of the payment of a dividend at a certain rate out of the profits disclosed by the balance sheet and accounts, whereas owing to the subsequent severe decline in the value of the currency floating capital insufficient resources were available. The fact, however, remains that a balance sheet would be drawn up quite correctly which did not provide for such a loss.

It is of interest to compare the principle on which currency book debts are valued for balance sheet purposes, with the principle on which book debts in general are valued, that is to say, in regard to what provision, if any, should be made for ultimate loss on realisation. Let it be assumed, for the sake of illustration, that among the debts owing to an English company at its balance sheet date were the following:—

(*a*) A debt of £100 from an English customer;

(*b*) A debt of 1,150 Argentine paper pesos from an Argentine customer, the sterling equivalent at the date of the balance sheet being £100.

Some four months afterwards, when the English company was completing the preparation of its balance sheet, it is ascertained that, owing to the insolvency of the English customer, only £80 would be received in respect of the debt of £100: and that as regards the customer in the Argentine, the debt had been collected in full in paper pesos, but owing to the fall in the Argentine exchange subsequent to the date of the balance sheet, the proceeds when remitted to England only amounted to £80.

As regards the English debt, it would clearly be incorrect to value it for balance sheet purposes at any figure in excess of £80. As regards the Argentine debt, however, it is submitted that the company would be perfectly justified in including it in its balance sheet at £100, although, as a matter of fact, it had ultimately only realised £80.

The distinction between the two debts may seem a somewhat narrow one, but it nevertheless exists. The decline in the value of the Argentine debt was attributable to circumstances arising entirely subsequent to the date of the balance sheet. Furthermore, a company undertaking business transactions with parties in a country having a fluctuating exchange must experience from day to day, as incidental to that business, losses or profits in exchange, either realised or unrealised, assuming, of course, that the transactions are on a currency basis. The only practical method of dealing with the situation, as between one financial period and another, when preparing accounts, is to revalue the currency floating assets and liabilities by reference to the rate of exchange prevailing at the date of the balance sheet and to deal in the accounts to that date with the profit or loss emerging; profits or losses subsequently accruing would then be regarded as belonging to the new financial period. Any attempt to earmark realised profits and losses in the new financial period as appertaining to the floating assets or liabilities existing at the end of the previous period, and to revalue these floating

assets and liabilities accordingly, is tantamount to attributing to the old financial period profits or losses which, from an accountancy point of view, really pertain to the new period. The provision for loss on a book debt owing to the default of the debtor is on an entirely different footing. It is the universal practice to make such provision in the light of all the information available at the time when the balance sheet is being completed: the argument that the provision was unnecessary because at the date of the balance sheet itself there was no knowledge of any impending default by the debtor would find no support among accountants.

While a clear discrimination between correct and incorrect accountancy principles incidental to the valuation of currency floating capital has been suggested above, it must not be assumed that in no cases is departure from such principles justified. Not a few public companies fail to maintain consistent principles; but this forms part of their policy with the express object of erring always on the safe side. For example, if a revaluation of the floating assets and liabilities at a balance sheet date discloses a profit, many public companies will not take such profit to the credit of their profit and loss account at that date, as it is not a realised one. If, however, such revaluation discloses a loss, they will see that provision for such loss exists in the accounts, either by means of a reserve created in some previous year, or, if no such reserve is available, by making a charge to profit and loss account.

V.—Stocks and Stores Purchased in Fluctuating Currency.

There now require to be considered points arising in connection with the treatment of stocks and stores purchased in the fluctuating currency.

As has already been mentioned, it is necessary to adopt such a method of accountancy in regard to these as will enable the actual or approximate cost of the stocks or stores on hand at any time, expressed in terms of the fixed currency, to be arrived at. This result can only be achieved by converting the purchase price of the stores from fluctuating currency into the fixed currency at or about the time when each purchase is made, at the rate of exchange then prevailing.

In the case of an undertaking such as a railway, or an electric light undertaking, the stores are bought for the purposes of operating, maintaining or improving the undertaking; in other words, they are purchased for use and not for sale. In the case, however, of an undertaking engaged in manufacture or trading, the stores are purchased with a view to re-sale either in the same form as that in which they were bought, or else in a more highly manufactured state. The treatment of stocks or stores falling under either category, so far as exchange is concerned, is, however, identical in principle.

Stores Purchased for Use.

Referring, firstly, to stores purchased to be utilised in the operation, maintenance or improvement of an undertaking, such as a railway, these, if purchased for immediate use, may be charged direct to the expenditure account to which they relate; that is to say, they will immediately form part of expenditure on revenue account or expenditure on capital account. But if, as most frequently happens, a stock of stores requires to be maintained, it is necessary to charge the stores, when purchased, to a stores account, and then, when a certain quantity of stores requires to be used, to credit the stores account and charge the appropriate expenditure account. It will be appreciated that it is essential to ensure that whenever stores which have been purchased in the fluctuating currency are charged out to an expenditure account, the expenditure account is debited with the original cost of such stores expressed in the fixed currency; and that it is also essential that at any time the cost of the stores in hand, expressed in the fixed currency, should be capable of ready ascertainment. The method adopted to achieve this is to keep the stores account in terms of the fixed currency. It hardly falls within the province of this paper—which deals with general accountancy principles rather than with detailed methods of bookkeeping—to describe the means by which this stores account is incorporated in the general book-keeping system, which system deals, of course, with the fluctuating currency in which the local transactions are taking place.

Stocks Purchased for Re-sale.

As regards stocks purchased for re-sale at a profit, the nature of the business may be such that the maintenance of a stocks account such as that described above is impracticable. Other means, therefore, have to be taken to ensure that the stocks in hand at the date of the balance sheet are valued at their approximate cost, represented in terms of the fixed currency. Differing circumstances in various businesses call for different methods of treatment; but the objective is the same. The scope of this paper does not permit of a description of any of these methods.

In referring to the principle that stocks and stores purchased in a fluctuating currency should be valued, for the purposes of a balance sheet prepared in fixed currency, at their cost, it should be observed that this is on the assumption, as regards stocks bought for re-sale, that there has been no decline in the market value (expressed in sterling) between the time of purchase and the date of the balance sheet. If, for example, a certain stock of material had been bought at the price of 12 Argentine paper pesos per yard at a time when exchange was at the rate of 12 pesos to the £, its cost per yard would be represented by £1. Let it be presumed that at the date of the balance sheet the Argentine peso was at the rate of 14 to the £, and that the market value of that particular class of stock was still 12 Argentine pesos per yard. The market price at the date of the balance sheet, expressed in sterling, would therefore be about 17s. per yard; and the stock would accordingly require to be written down, for balance sheet purposes, from its cost of £1 per yard to the market value of 17s. per yard.

VI.—INVESTMENTS.

Before leaving the subject of assets, it is desirable to say a few words in regard to investments in companies domiciled in countries having a fluctuating currency.

In connection with the preparation of the annual accounts of the concern which owns such an investment, the question of the value of the holding may arise, as may also the question of what income can be taken credit for as being derived from the ownership of that investment. In that connection the balance sheet and accounts of the company in which the investment has been made may require to be reviewed. These accounts presumably are expressed in terms of the fluctuating currency, and the question at once arises as to what rate or rates of exchange should be applied to the currency figures appearing therein in order to show their fair equivalent in terms of the stable currency.

For example, let it be assumed that a limited company in England owns the whole of the share capital in a Brazilian company and that the balance sheet of the Brazilian company (which would be expressed in milreis, the currency of that country) may be summarised as follows :—

Balance Sheet.

	Milreis.		Milreis.
Share capital ..	100,000	Debtors ..	136,000
Creditors ..	50,000	Cash	19,000
Credit balance on profit and loss account	5,000		
	155,000		155,000

Let it be presumed that the English company had acquired the whole of this share capital in the above company at par at a time when the value of the milreis was 6d. And let it be presumed that at the date of the foregoing balance sheet the value of the milreis was 5d.

The investment would first appear in the books of the owning company at cost, namely, £2,500—*i.e.*, 100,000 milreis at 6d.

At first sight it might seem as if this investment was fully represented, at the date of the balance sheet quoted above, by tangible assets, because not only are the 100,000 milreis intact, but 5,000 milreis have been added in the form of profits earned and retained in the business. But such is not the case when the balance sheet is reviewed from the standpoint of sterling, as the 105,000 milreis at 5d. are only equivalent to £2,187 10s. Therefore, from the point of view of the English company which owns the investment, the shareholding is unrepresented by tangible assets to the extent of £312 10s.

In the case quoted above it has been assumed, for simplicity's sake, that the Brazilian company has no fixed assets. If, however, it happened to own fixed assets as, for example, land and buildings, the rate of exchange at the date of the balance sheet would not, as regards assets of this class, have any significance. The fixed assets would require to be valued by reference to the rate of exchange prevailing at the time when they were acquired or constructed.

VII.—OPERATING PROFITS EARNED OR LOSSES SUSTAINED IN A FLUCTUATING CURRENCY.

Average Rates of Exchange to be Adopted for Conversion Purposes.

There now requires to be considered the method by which profits earned (or losses sustained) in a fluctuating currency should be converted into terms of a fixed currency. The general basis, as already mentioned, is that they should be converted at the average rate of exchange prevailing during the period.

In regard to the length of the period in respect of which the daily average rate of exchange should be taken, similar remarks apply as in the case of the conversion of expenditure incurred on capital account, namely, that the more evenly the profits are earned, and the less widely the exchange fluctuates, the longer the period that can safely be taken. It may, for instance, be quite justifiable to take a period of as long as a year. If, however, the profits are not earned more or less evenly over the year, and if the fluctuations in the exchange are considerable, shorter periods will probably require to be taken, say, periods of six months or three months, or of one month. In certain kinds of business—and especially in those classes of business where heavy stocks of raw or of semi-manufactured material have to be held—the ascertainment of the profits in terms of the fluctuating currency at so short an interval as each month may involve a considerable amount of additional accountancy work. If, however, reasonably accurate results can only be obtained by these means, no other course is open. The circumstances of each case must be carefully considered on their merits before a conclusion is reached as to what should be done in this respect. On the one hand there is the natural desire to avoid all unnecessary trouble and expense; but, on the other hand, if proper reliance is to be placed upon the periodical statements of account, these must be accurate enough for all practical purposes.

It may be well to observe here that the figure of profits, arrived at in terms of the fixed currency, as the result of converting at the average rate of exchange profits earned in the fluctuating currency, is not a final figure, but will always need some adjustment.

Leaving out of consideration for the moment accounts of businesses where the conversion of fluctuating currencies arises, it will be appreciated that under a double entry book keeping system the correctness of the figure of profits shown by a profit and loss account is in effect proved by the preparation of a balance sheet; in other words, if profits have been earned they are represented by an accretion in the assets of a business or by a reduction in the liabilities, or partly by one and partly by the other. It is, as a rule, impossible or impracticable to earmark any particular asset as representing any portion of the profits earned in a period, or to earmark the reduction in any particular liability as being due to the same cause. Floating assets and liabilities are

fluctuating in amount from day to day: individually, they may increase or decrease quite irrespective of the amount of profits being earned. If, however, there is an increase in the excess of the assets over the liabilities as between two dates (after making allowance for any fresh capital introduced or any moneys drawn out) it can definitely be said, in a normal case, that this is due to profits having been earned during such period.

The foregoing principles may now be considered in relation to a business which is operating in a country whose currency fluctuates, but which is owned by parties in a country with a fixed currency.

Profits and Losses to be Adjusted by Differences in Exchange.

Let it be assumed that such a business was operating in the Argentine Republic and that it earned, in a financial year, 100,000 Argentine paper pesos, and that the average daily rate of exchange for that period was 12 Argentine pesos to the £ sterling. The profit and loss account would then show a profit, in terms of sterling, of about £8,333. There are, however, other factors affecting the true profit of the period which will not yet have been taken into account. In practice, a number of these factors are usually present in conjunction; but for the sake of simplicity it may be well to consider an example in which two factors alone exist.

Let it be presumed that in drawing up the balance sheet of the business, the profit of 100,000 Argentine pesos, which has been earned, is represented as follows: 80,000 pesos were remitted to England towards the end of the financial period on a date when the rate of exchange was 14 pesos to the £; these therefore realised about £5,714 and formed part of the bank balance in England at the balance sheet date. The balance of 20,000 pesos was represented by a bank balance in the Argentine at the balance sheet date. In common with other floating currency assets it was converted, for purposes of the balance sheet to be prepared in England, at the rate of exchange at the balance sheet date. Such rate was 14½ pesos to the £, and the balance was therefore valued at about £1,380.

Summarising the position, therefore, the 100,000 Argentine pesos, representing the net profit, which had been converted for book-keeping purposes at the average rate of exchange, and were expressed in sterling at £8,333, were, at the balance sheet date, found to have a value of only £7,094 (namely, £5,714 plus £1,380). There was therefore a loss on exchange, which arose partly from the fact that the bulk of the profits earned were remitted at a lower rate of exchange than that at which the figure of profits had been converted for book-keeping purposes, and partly from the fact that the portion of the profits which had not been remitted but had remained in a local currency bank account had declined in value by the balance sheet date.

In the example just considered it had been assumed that the whole of the remittance made was in respect of profits earned during the financial period in question. In practice, however, a remittance made during a particular financial period may be made out of funds arising from the realisation of currency floating assets in existence at the beginning of the period. If the rate of exchange at which such remittance is made is more favourable than the rate adopted for valuing the currency floating assets at the beginning of the financial period (that is to say, at the date of the previous balance sheet), a profit on exchange would automatically emerge. Such a profit would not, it is true, arise out of the operations of the company on what may be called trading or working account during the period; but it is, nevertheless, a profit attributable to the period, as it has arisen during the period and is in respect of a floating asset.

Again, a remittance may not be wholly in respect of profits. The remittance may, in part, be in respect of stocks and stores which, let it be presumed, are purchased in England and dispatched to the Argentine. If the rates of exchange at which the remittances are made are different from the rates prevailing when the stores are dispatched from England to the Argentine, a difference in exchange —either a profit or a loss—emerges in respect of this.

From what has been said above, it will be appreciated that it is generally impracticable—as it is also unnecessary—to ascertain the exact composition of a difference in exchange arising at the end of a financial period on the compilation of a balance sheet. Whatever difference emerges will require to be written off to profit and loss account—except, of course, to the extent to which it may be a difference attributable to capital. This latter matter has already been discussed.

Origin of Difference in Exchange.

While, however, it may be impracticable to endeavour to ascertain the exact composition of a difference in exchange appearing on the drawing up of a balance sheet at the end of a financial period, it is well to consider whether the difference which does emerge is in accordance with general expectations, having regard to the course of exchange throughout the period and other factors. If it does not accord with what might be expected, the matter should be looked into, having regard to the possibility of some book-keeping error having been committed.

Conversion of Profits at Average of Remittance Rates.

The suggestion is sometimes put forward that instead of the profits being converted at the average rate of the period during which they were earned, they should be converted at the average rate at which actual remittances were made during such period. By this means, it is argued, a smaller difference in exchange will emerge in the accounts. This may very well be the case; but it does not therefore follow that the accounts are more accurate. In fact, the reverse is probably true. The profits of a business are earned from day to day; but remittances of such profits to the country having the fixed currency do not usually take place daily, but at longer intervals, partly because very frequent remittances entail corresponding time and trouble, and partly, it may be, with the object of retaining

funds temporarily in the fluctuating currency until such time as the exchange rate seems favourable for a remittance. The true operating profits are, therefore, fairly represented by the conversion of the currency figures, for bookkeeping purposes, at the average of the daily rates prevailing during the period; and the difference arising in connection with the remittances is not an operating profit or loss but a financial profit or loss on exchange, and as such should be shown separately. Any attempt to merge it with the operating profit, which in effect would be the result of adopting the remittance rates for the conversion of the profits figure, is therefore to be deprecated.

It will now be appropriate to refer to one or two general matters in regard to the treatment of fluctuating currency in accounts which do not fall conveniently into any of the sections into which this paper has so far been divided.

The first of these concerns the question of accuracy.

VIII.—Degree of Accuracy of Accounts.

While one of the essentials of an accountancy system is accuracy, it must always be remembered that absolute accuracy may not be essential, but that relative accuracy may sufficiently meet all requirements. It will be clear from the description of the bases of conversions from terms of a fluctuating to terms of a fixed currency, for bookkeeping purposes, that the adoption of an average of the daily rates of exchange for the purpose of converting the gross revenue and expenses of any financial period produces figures which are not accurate in the strictest sense, though they are approximately correct. If the margin of error is obviously very slight, it can certainly be ignored. One obvious method of practically eliminating the margin of error would be to convert the figures relating to the revenue and the expenditure of each day at the rate of exchange prevailing on that day; but this would clearly entail an enormous amount of additional clerical work, the necessity for which it would be difficult to justify.

In reviewing, in individual cases, the probable margin of error and in coming to a decision as to whether its existence is justified, or whether some more accurate (but more elaborate) method of conversion would be desirable, an important point to consider is whether the error is one which is automatically corrected (either in the accounts of the same financial period or in those of a subsequent financial period) or whether it is of such a character that it will be perpetuated.

The above observation calls for some short explanation. In a business where no addition to fixed assets is taking place (in other words, where no expenditure on capital account is being incurred) any profits earned must be represented by an accretion to the floating capital, or else by remittances to the country having the fixed currency, that is to say, the country where the owners of the business are domiciled. If by reason of a somewhat arbitrary basis of converting the figures representing the gross revenue and the expenditure from fluctuating to fixed currency, for bookkeeping purposes, the profit is somewhat understated or somewhat overstated, this profit figure is automatically adjusted, partly by the exchange profit or loss on remittances, and partly by the revaluation of the currency floating assets less liabilities at the date of the balance sheet at the rate of exchange then current. Within limits, therefore, it is immaterial, in such a case, whether the profits are ascertained monthly and converted at the average of the daily rates for the month, or whether they are ascertained quarterly, half-yearly or yearly and converted respectively at the average daily rates for the quarter, half-year or year. A different profits figure is arrived at in each case; but in each case a different exchange profit or loss figure emerges; and when the two figures are taken in conjunction the result is exactly the same in each case.

The fact, however, that the net profit ultimately arrived at is the same is no necessary justification for adopting arbitrary rates of exchange in converting the currency figures of expenditure and gross revenue in the profit and loss account and then showing on the books a large difference in exchange which is thereupon written off to profit and loss. In such a case, the difference in exchange does not wholly represent a real profit or loss on exchange, but would be composed to a considerable extent of differences arising from what may aptly be termed loose accountancy methods. The aim of accountancy as regards a profit and loss account is not merely to disclose the ultimate net profit, but to show as accurately as possible how such profit has been earned. And in that connection it may be very desirable that the account should clearly discriminate between a profit on what may be called trading or operating account and a profit on exchange. The point may, for example, be of special importance where the profits of a business for a series of years have been reviewed incidental to the possible sale of such business, or where profits are being quoted in a prospectus offering the shares or debentures of a limited company for subscription by the public. Or, again, it may be desired to compare figures of expenditure and of revenue, class by class, over a series of years. In this case it is clearly necessary that the conversions of these figures from terms of fluctuating to terms of stable currency should be made, as regards each year, on the most accurate basis which is practicable, as otherwise the comparison may lose much of its value.

If, however, capital expenditure is being incurred in the fluctuating currency, and the method of converting the currency figures representing this expenditure into terms of the fixed currency is too arbitrary and a material inaccuracy results, such inaccuracy, as mentioned earlier in this paper, is perpetuated, as the capital expenditure is permanently embodied in the books either at too high or too low a figure. This means that the profits of the financial period ended on the date of the balance sheet have either been overstated or understated. The same overstatement or understatement of profits exists, of

course, if a currency floating asset has been converted, for book-keeping purposes, at too high or too low a rate of exchange. A currency floating asset, however, is not permanent: it changes in form from time to time and is subject to revaluation or to realisation into the fixed currency. To what extent, therefore, it has been overvalued or undervalued at the end of one financial period (thereby affecting the profits of that period as shown by the books) a corresponding adjustment automatically takes place during or at the end of the next financial period.

IX.—Requirements of a Scientific Accounting System.

The maintenance of a proper system of dealing, in accounts, with a fluctuating currency involves, it must be admitted, certain additional clerical work. Furthermore, the system cannot be wholly free from complications. Neither the additional work nor the complications are, however, so great as might at first sight be imagined.

So far as the additional clerical work is concerned, it will be remembered that in the main the conversions from terms of the fluctuating to terms of the fixed currency deal with totals and not with individual terms. And as regards the complications, these are apt to disappear when once the main principles to be borne in mind and the main objects sought to be achieved are thoroughly understood.

In practice one not infrequently experiences cases where those owning or administering a business which is being carried on in a country whose currency fluctuates, allow the records to be dealt with throughout a financial period on a basis which assumes that the currency is a fixed one. Then, at the end of the financial period they seek to make the necessary adjustments in preparing the balance sheet, and if insufficient data exists—as is very probable—for the purpose of making proper adjustments, they are content to make approximate adjustments; and they claim that the accounts will then be sufficiently accurate for practical purposes. Their avowed object, of course, is the saving of time and expense.

It is hardly possible to emphasise too strongly the inadvisability of such a procedure. The saving of time and expense is a trivial benefit to set against the possibility that the accounts so prepared may be inaccurate to a material extent, bearing in mind that no adequate means are then probably available to prove whether all necessary adjustments have in fact been made.

X.—Concluding Observations.

Before bringing this paper to a conclusion, the writer wishes to make a few general observations.

In the first place he desires to make it clear that all the points discussed and principles laid down have been dealt with from the standpoint of British accountancy practice and British law.

The second observation is that anyone attempting to prepare a paper upon a somewhat specialised subject is under a peculiar difficulty if he knows that some of his audience have had a wide practical experience of the matters treated, while to others many of the points discussed constitute new ground. To those of the audience who fall under the first category, apologies may be needed on the ground that the subject matter of the paper is unduly elementary. On the other hand, those who belong to the second category may quite conceivably complain, with perfect justification, that too great a knowledge of the subject on their part has been taken for granted and that, as a consequence, they cannot appreciate fully some of the explanations given or arguments used. Of both classes of audience, therefore, the writer has to ask indulgence.

Apart altogether from the advantages which an International Congress of Accountants confers on us as professional men in the interchange of views and ideas on accounting and kindred subjects, there are the wider benefits which we all derive from mixing with each other as citizens of various countries in friendly intercourse. By so doing we may hope to obtain some insight into each other's outlook and mentality, and to appreciate something of the special difficulties and problems with which each nation is confronted.

In spite of the greatly improved means of communication which science has placed at man's disposal in recent years, each nation still lives largely in a watertight compartment, created in part, it is true, by geographical conditions, but due in no small measure to the restrictions imposed by different languages, different laws, different fiscal systems, different currencies. And, greater still, by far, are the difficulties which have their origin in unstable forms of government and unsound national finances. It is to be hoped that, in course of years, the ingenuity of man will overcome these man-made barriers, which can only be a hindrance to international intercourse, and therefore to international amity. One such barrier is that represented by a fluctuating currency. But we can, at least, say this—that the more the realisation of the existence of this barrier is brought home to the world, the greater the possibility that in course of time means may be found by which it can be overthrown.

Discussion on Mr. Cutforth's Paper.

Dean N. Butculescu (Roumania), in opening the discussion, said that one of their problems—and a very important one—was that of inventory valuation. It was such that it could alter the results of the balance sheet and profit and loss account. This was what the accountant tried to make clear, by taking as a working basis what he considered to be a true estimate of the circumstances in which the balance sheet had been struck. After the Great War, the instability of currencies provided a new aspect of the problem of valuation for accountants, although the problem was already complicated enough. The results of currency instability were felt with greater intensity in those countries where money depreciated most. That was the case in Germany, where the first experiments and attempts were made to enable accountants to fulfil their function, namely that of presenting a business in its true light, and of showing results comparable with previous ones and with those of similar businesses, not only in normal times, but even during periods of marked currency fluctuation. This problem was still to the fore, though less urgently, in England and the United States of America. They had it also in Roumania. During the years directly following the Great War, accountants disregarded these fluctuations and

adopted paper money as a basis for their records. Generally speaking, their balance sheets showed extraordinary profits, which gave the illusion of prosperity and enabled large dividends and bonuses to be distributed, whilst also enabling the Treasury to collect large sums in taxes. People such as Professor Prion and others, whose acquaintance with the science and technique of accountancy entitled them to speak with authority, drew attention as early as 1919 to the disastrous consequences of these deceptive balance-sheets; but accountants and heads of business concerns did not, or would not, realise these consequences in time to apply the principles of correct accountancy to businesses and their results. At a time of exchange fluctuation, it was necessary to take the Gold Standard as our basis, just as old-time navigators took their direction from the Polar Star. The Gold Standard might have its defects, but until they found another reliable compass, which would be an ideal standard, gold would remain in the near future and probably for many a day the best unit of measure for prices. Amongst the accountancy methods which had been tried in the effort to counteract errors of valuation during currency fluctuations, were the following:—(*a*) The creation of additional reserves, either open or secret, by undervaluing assets; (*b*) Extraordinary amortisations, obtained either by adopting a higher quoted rate of exchange, or by estimating them at the figure of stocks and stores revalued at the current price; and (*c*) To convert the business into a limited company and to increase the capital by writing up the assets. That operation made it possible to provide for depreciation up to an amount equal to the value of the assets in depreciated currency. The awkward side of the procedure was that the Treasury must then be convinced that no tax should be levied on the difference between the initial value and value in the depreciated currency, for the very good reason that no alteration had taken place in the intrinsic value of the holding. All these methods of counteracting the effects of currency depreciation were merley palliatives. It would appear that the real solution for the problem of recording values and showing real profits and losses at times of exchange fluctuations would be to adopt a fixed standard, at any rate for domestic accountancy. This gave rise to the idea of accounting and setting up the balance sheet in double columns, one column being for the gold value and the other for the value in paper money.

Mr. B. G. LONGSTAFF, A.L.A.A., said that in the short time at his disposal he had only one small comment to make. In connection with the charge for depreciation on fixed assets situated in a country which they, in England, would call foreign, they all knew that at the time when those fixed assets were acquired, the rate at which to convert the purchase price of those assets should be the rate prevailing at the time. At first sight, it would appear necessary, in order to arrive at the annual charge for depreciation, to calculate the life of an asset and divide the purchase-price by the number of years, but with currencies fluctuating as they were to-day, it was necessary to change that annual charge for deprecation so as to conform with the fluctuations in the exchange.

Mr. WALTER HOLMAN, F.S.A.A., said that Monsieur Van Dien's presence in the chair that morning reminded him very vividly of the Second International Congress at Amsterdam in 1926. As one of the delegates to that Congress, he would like to digress for a moment in order to say how pleased they were, having appreciated and enjoyed their Dutch colleagues' generous and delightful hospitality on that occasion, to be able to make some return. It was particularly appropriate that this paper on fluctuating exchanges should come immediately after the paper on International Finance to which they had listened, because the former represented practical accountancy applications to those difficulties which were dealt with in the latter and which the subsequent discussion had done so much to elucidate. In his closing observations, Mr. Cutforth referred to the difficulty of dealing with a technical subject in such a way that it would prove acceptable and intelligible both to those who had practical experience of the subject and to those who had little or no experience. Under whichever category they came—and modesty forbade them to classify themselves—they would, he thought, all be agreed that Mr. Cutforth had overcome his difficulty with complete success, for he had made a difficult subject appear to be simple and he had given them a paper which, for clarity of expression and thoroughness of detail, would hold a high place in the records of the Congress. The writer of the paper had laid down principles and indicated their application so completely in accordance with accountancy practice, that he would be a brave man, or a foolhardy one, who would attempt to dispute them. But he thought Mr. Cutforth would be the first to agree that difficulties must arise in applying those principles in practice, and there was a necessity for dealing with each case on its merits and using discretion in the application of those principles. Even in the most efficient accountancy system, a period must elapse between the date of the balance sheet and the date at which the balance sheet was prepared, and in that period great differences in values might occur, in these days particularly, owing to the fluctuations in exchange. Mr. Cutforth had laid it down as a principle that the date of the balance-sheet was the date at which the values should be fixed, and had said that any profits or losses which became apparent between the two dates were properly profits or losses relating to the subsequent period. He (Mr. Holman) wished to submit that while it would be unwise to fail to make provision for a loss on exchange merely because there had been a subsequent rise, and still more unwise to anticipate a profit from that cause, yet it would be sound business and sound accountancy to make provision for a loss at the time of the balance sheet, either by way of a direct allocation of available profits or by a note in the balance sheet. In the section of the paper dealing with currency and floating assets, a distinction was drawn between stores purchased in the fluctuating currency and other floating assets similarly purchased. He could not quite follow the reason for drawing that distinction. Mr. Cutforth admitted that goods which were purchased for re-sale must be revalued at market price at the date of the balance-sheet. If he (Mr. Holman) was right in interpreting the use of the word "stores" as representing goods which were purchased for the purpose of use in manufacture, then he could see no difference between such stores and stock in trade. Any loss in value represented a loss of revenue which should be provided for. (Applause.)

Monsieur J. C. A. VAN DER SPIL (Holland) said that in the first place he wanted to point out that he differed from the opinion expressed by Mr. Cutforth that capital expenditure incurred in fluctuating currency should be converted into the fixed currency at the rate of exchange prevailing when the expenditure was incurred. In the case of very small differences they might do so, but in the case of large ones they could only follow the rule, whereby against the depreciation of a certain currency they found an equivalent in an equal increase of prices in the country where the currency depreciated. This would be in general a theoretical supposition. The practice would be that when a currency was depreciated the possibilities of making profits from the standpoint of the foreign owner, who calculated in gold, would be decreased. Especially would this be the case when the Government seemed to be able to maintain the level of the prices at the same basis as the currency was when the expenditure was incurred. It might be that, as far as raw materials were concerned, that was on account of a decrease in prices. But when their quotation went up it was not likely that the costs of the labour would follow to the same extent as the devaluation of the English currency. It followed that under these circumstances the possibilities of making profits calculated in gold would be less, and moreover they had to reckon with the fact that the costs of capital expenditure in future, calculated in gold, would also be reduced. Another important problem would arise when the home currency was depreciating as in Germany in 1921-23 by the depreciation of the German mark. In that case the German merchant would have got absolutely wrong figures of the results on the theory that in regard to the home currency

we need not worry, as he understood from what the writer of the paper had said. Let them hope that the main currencies would be stabilised in the near future. In that way the pound sterling would regain its brilliant position in the world.

Mr. C. H. WELLS, F.S.A.A., said that though it was not usual to take credit for a profit disclosed on a re-valuation of floating assets and liabilities, yet it should not be overlooked that such a state involved a hidden reserve, on the propriety of which much difference of opinion existed, and which might afterwards be drawn upon, with results which were sometimes deprecated. Regarding forward purchases of currency, apart from the accounts of companies with holdings abroad, few accountants were without experience of dealing with remittances in foreign currency at a future date to meet obligations incurred there. It was a frequent practice, indeed a prudent course, to buy currency through an exchange broker at a forward date, thus making the results of the transaction certain, apart from the question of profit, and eliminating the element of gambling consequent upon exchange fluctuations. The risk would thus appear to be transferred to the broker, except that for the fact he had probably a number of transactions *per contra* in the same currency at similar dates, so that if his business or turnover was sufficiently extensive, he was able to supply or receive approximately equal consignments of currency at the same rate, covering himself against loss, the commission charged to all parties representing his certain profit.

Monsieur ING J. FUKATKO (Czecho-Slovakia) said he brought the heartiest greetings and best wishes for full success to the Congress from a country situated in the geographical heart of Continental Europe, on behalf of three bodies of expert auditors in Czecho-Slovakia and on behalf of the College of Business Administration in Prague, which he had the honour of representing. He did so with particular pleasure in the capital of a country to which his nation was greatly indebted for unselfish and generous aid in its struggle for independence during the Great War. In Czecho-Slovakia they had the same trouble as existed in England by reason of the rate of exchange, and in 1927 they made a law to remedy those difficulties, and one of the principal articles of that law was that any profits that came from a rearrangement must not be used for dividends but be put into reserve or written off. (Applause.)

Mr. DEAN J. C. MYER, C.P.A. (U.S.A.), said that he would first of all like to express the appreciation of the American Society of Certified Accountants and the Jersey State Society for Mr. Cutforth's excellent treatment of a difficult subject. He was sure that the paper would have a far-reaching effect even upon individual practices, and it would find its way into the teaching of accountancy. As a school man he knew that the literature of exchange was not up to date, and Mr. Cutforth's paper would serve a useful purpose in that connection. The scope of his topic was not broad enough for Mr. Cutforth to give his solution for the present ills in regard to foreign exchange, and that gave him (the speaker) an opportunity of making a recommendation which he had wanted to make for a number of years—that accountants all over the world should take more interest in public affairs, and particularly those in which occurred problems of foreign exchange between various countries. He would like to recommend that when the next Economic Conference was convened, in the delegation from every country there should be at least one authorised, chartered or certified public accountant, not merely as an adviser to the Commission but as a delegate who could speak with authority. He was greatly impressed by the fact that all those attending the Congress, no matter from what country they came or what the conditions in those countries were, understood each other's practice, and he was sure that if they all took more interest in and became members of tariff commissions, economic commissions and any other similar body, they would help to solve international problems and might find a solution just a little faster than was possible under present conditions. He would also recommend that all of them, particularly those in the United States, should take more interest in public affairs. He believed that the training, conservatism, stability and practical experience of accountants were necessary to eradicate the ills of widely fluctuating exchanges. (Applause.)

Mr. J. G. BHANDARI (India) said that Mr. Cutforth had exhaustively and ably dealt with the question of exchange flucutations in relation to commercial accounts, and he would venture to draw attention to another aspect of the problem, namely, the question of exchange fluctuations in relation to Government accounts. He came from India and was the Accountant-General of the Posts and Telegraphs. The accounts of the Government of India were kept in rupees while a certain portion of the expenditure was incurred in England. The expenditure incurred in England, sub-divided under the proper heads, was converted at certain rates into rupees and shown in the Indian accounts under the corresponding heads, while the difference between that artificial rate and the real rate of exchange was shown under the leading of "Gain or loss on exchange." In normal conditions that system was all right for practical purposes and probably fulfilled the test prescribed by Mr. Cutforth, but in certain conditions it was not so satisfactory. For instance, during the war period the rupee exchange went up to 2s., and by that system a large portion of the expenditure under various heads was shown under "Gain or loss on exchange." In Government accounts it was essential that for purposes of comparison the same standard should be maintained. One liked to compare expenditure with what it was, say, 50 years ago, and, if the rate of exchange had varied considerably the comparison was misleading. It would be very interesting to know how that problem was dealt with in other countries. (Applause.)

Mr. WILLIAM CASH, F.C.A., said that he would like first of all to congratulate Mr. Cutforth on his paper, both on its structure and on its matter. He would venture to suggest that after taking them through the logical reasons which led up to the practice, he had in his paper set out what might be described in this country as the best accountancy practice for dealing with the accounts of undertakings carrying on business abroad. The difficulties which arose to-day were very great in two particulars, first, as regarded fluctuations in exchange, which took place so continuously, and secondly, with regard to credits and balances abroad. When they considered that the object to be attained in setting forth accounts of an undertaking carrying on business abroad was to represent the true position here in the currency of the owning undertaking, that, he thought, was the real line which defined the method to be followed in accountancy practice. Then Mr. Cutforth suggested that the most useful way of stating the earnings over any period was to take the average rate ruling over that period for the purpose of converting profits into the home currency. He (the speaker) had had some experience of auditing and also in the administration of businesses carrying on operations abroad, and he would venture to say that that really was the most satisfactory way of dealing with the matter. There was one additional reason for saying that. If, as frequently arose, there was a necessity for reviewing the charges or the earning capacity of any particular undertaking in relation to the capital employed therein, they got a much more accurate result of such business transactions or profit earned during any financial period by adopting the average rate ruling during that period. Then Mr. Cutforth made it clear, so far as the accuracy of the balance sheet was concerned, that any inaccuracy in the profit and loss account was corrected in the balance-sheet by writing the floating assets down or up to the rate ruling at the date of the balance sheet, and in that respect he entirely agreed with Mr. Cutforth's views. (Applause.)

Mr. Cutforth's Reply.

Mr. CUTFORTH said he hoped that if any of the speakers did not find their queries answered they would excuse him because the time was limited. Mr. Butculescu had dealt with the subject from quite a different angle from that dealt with by him in his paper. He was considering the case of where a balance sheet and profit and loss account had to be presented to the owners of a business in the currency of the country where the owners resided,

but where the business, in whole or in part, was being carried on in another country. Mr. Butculescu dealt with a business carried on in one country only, but in a country where the currency had fluctuated very widely in its relation to gold, and suggested that in such a case it might be necessary to take the gold standard as a basis, or alternatively to show the balance sheet and profit and loss account in two sets of columns, namely, firstly, the paper currency of the country, and secondly, the gold equivalent. He (Mr. Cutforth) appreciated that good reasons could be put forward in support of this, particularly in countries where the fluctuations had been very extreme, and he agreed with much of what Mr. Butculescu said. At the same time, there were possible objections to such a procedure. One objection was that to people in a country having a paper currency, figures expressed in terms of gold were largely meaningless. A second difficulty was that gold had by no means a fixed value when measured by commodity prices. One could take an illustration from our own country. In the spring of 1931 we were on the gold standard, and our pound was in effect a gold coin. Now we were off the gold standard and our pound in comparison with the gold pound was only worth about 14s., but owing to various causes, including the world-wide fall in commodity values and the improvement in labour-saving devices, many things could be purchased cheaper in our currency to-day than they could be purchased in the spring of 1931. In other words, £1 of paper money could often purchase more to-day than £1 of gold money could purchase two years ago. Mr. Longstaff, in reference to depreciation of fixed assets, rather suggested that the subject had not been dealt with very fully, but if he referred again to the Paper he would see that the particular point raised by him was in fact discussed. He very much appreciated the kind remarks of Mr. Holman. One of the greatest difficulties in preparing such a paper was to make it simple enough for people who had not had much previous experience of exchange and yet to make it sufficiently informative and interesting to people who had practical experience. With reference to losses arising subsequent to the balance sheet being received by reason of the floating assets going down, he agreed that as a measure of prudence it would be well and justifiable to make a reserve in that connection. All he would say was that no one had yet been successful in persuading the income tax authorities here to accept that method of reviewing the profits of any particular period. (Laughter.) Another point made by Mr. Holman was in connection with stocks of stores. He said it had not been explained why, if the market value of stores went down at the date of the balance sheet, stores should be still valued at cost. I was considering in that connection not stores which were to be manufactured for re-sale but stores of materials for use in the business itself, such, for example, as sleepers in the case of a railway company—engineering stores. It was not the practice in a case like that, merely because the value of stores which had been bought in a fluctuating currency was lower at the date of the balance-sheet to bring those materials into the balance sheet at that lower figure. The general practice was to have regard to what they actually cost and, when they were issued and thus formed part of the expenditure on the line, they were charged up at what they cost. Then Mr. Van der Spil referred to the question of a Dutch company which had bought property over here in florins, and where the rate of exchange varied very much subsequently to the purchase. He (Mr. Cutforth) still felt that he must adhere to his view in regard to such a situation and say that the Dutch company should still show how many florins they had actually paid for the property. It was a matter for consideration whether in view of the fluctuations in exchange the directors cared, as a matter of policy, to write the asset down, but, on the question of current values, they were on entirely different ground, and he suggested that they must adhere to the basis which was always adopted over here in regard to such assets, namely, to state them at their cost and maintain them in the balance-sheet at that figure, subject to what might be considered necessary to write off for depreciation. What it might cost to replace these assets at some subsequent date, that cost being either greater or less by reason of exchange fluctuations, did not enter into that particular problem. The only other remark he wished to make was to say how much he appreciated the kind comments of Mr. Cash, especially as he was an articled clerk of his some 30 years ago, and then learnt from him a great deal of what he knew now. (Applause.)

The CHAIRMAN said that before leaving the chair, he wished to express his personal thanks to Mr. Holman for the nice things he had said about Holland and also to Mr. Cutforth for his most instructive paper upon a most difficult matter. They in Holland had had that difficulty for many years in connection with the currencies of the Dutch East Indies. He wished to express his thanks to the author of the paper and also to those who had expressed their views upon it.

A Paper was then read on

HOLDING AND SUBSIDIARY COMPANIES.

Accounting Principles involved in the Treatment of Earnings and Valuation of Holdings.

BY

Sir ALBERT W. WYON, K.B.E., F.C.A.

Colonel R. H. MONTGOMERY occupied the chair.

Sir ALBERT WYON said:—

Problems relating to the accounts of Holding and Subsidiary Companies form an appropriate subject for discussion at this international gathering, as to some extent they arise from the fact that the operations of many commercial undertakings are carried on in more than one country. The foreign subsidiary presents all the problems of the domestic subsidiary and some additional difficulties, especially since the partial breakdown of the exchanges which we have witnessed in the recent past. Moreover, increased public interest in the subject has been aroused in more than one country in the last year or two as the result of disastrous failures of groups of closely allied companies.

The subject is a difficult one, and in attempting to deal with one phase of it to-day I cannot fail constantly to be reminded of the loss we have all sustained through the death of Sir Gilbert Garnsey, who was to have prepared a paper upon this subject to be submitted to this Congress and who, by reason both of his brilliant gifts and his long-continued interest in the subject, was especially well fitted to do so.

You will note that I have been asked to deal with accounting principles, and questions of law will only be touched upon incidentally as may seem necessary.

As regards existing law, so far as I have been able to ascertain, the attempts of legislatures to deal with the subject have been few and ineffective. I cannot forbear mentioning as an illustration the legislation in this country embodied in the Companies Act, 1929. That Act requires that certain particulars shall be disclosed to the members of a holding company relating to the trading results of its subsidiaries. The particulars briefly epitomised are as follows: A statement signed by directors is to be annexed to the balance sheet of the holding company stating how the profits and losses of the subsidiary company, or where there are two or more subsidiary companies,

their aggregate profits and losses, have, so far as they concern the holding company, been dealt with in that company's accounts, and it is required in particular that the statement shall contain information as to how and to what extent (*a*) provision has been made for the losses of a subsidiary company either in the accounts of that company or of the holding company or both, and (*b*) losses of a subsidiary company have been taken into account in arriving at the profits and losses of the holding company. It is specifically provided, however, that it shall not be necessary to specify the amount of the profits or losses of any subsidiary company or the actual amount of any part of such profits or losses which has been dealt with in any particular manner.

I venture to think that the particulars required by the Act to be disclosed are of so general and vague a character as to be quite insufficient to supply shareholders with the information necessary for them, if they are to have a just view of the earnings of the enterprise in which they are interested and of its prospects. The provisions which I have epitomised may indeed have the unintended effect of providing justification for directors who wish so to prepare the accounts of a holding company as to conceal from those chiefly interested the actual results of its activities.

Definition of Holding Company.

In my experience, which dates back a good many years, the term "holding company" was first used to describe a company formed for the express purpose of combining the interests of a number of companies or firms carrying on similar or related businesses. The process consisted in the incorporation of a company and the issue by that company of its shares in exchange for the shares (in some cases the ordinary shares only) of the existing companies, any firms proposed to be acquired being converted into companies for the purpose. The business of the holding company was confined to the supervision of its subsidiary companies and the receipt and distribution of dividends received from them.

Since those early days the conception of a holding company has been widened, and now includes companies which, in addition to holding interests in subsidiary companies, may carry on very important business operations on their own account. A subsidiary company may represent a business acquired, or what was formerly a part of the business of the holding company or of other subsidiary companies, or perhaps even a mere device to facilitate financial operations or to avoid publicity.

The term "subsidiary company" is to-day not restricted to companies of which all the ordinary shares are owned by the holding company. It is applied variously, but I would say that a fair definition of a subsidiary company would be a company of which the holding company possesses voting control either through a shareholding in the subsidiary itself or through shareholdings in another company or companies. British accountants will realise that this definition is wider in its scope than the definition with which they have been provided in the Companies Act, 1929, since the statutory definition in that Act is not so framed as to include sub-subsidiary companies.

The facts that subsidiary companies themselves have subsidiary companies and that subsidiary companies may be incorporated in a jurisdiction different from that of the holding company make the problem exceedingly complex.

The wholly owned subsidiary company and the subsidiary company in which only a majority interest is owned, stand on different bases.

For practical purposes it seems to me that subsidiary companies may be classified into groups—at the one extreme are companies which are wholly or substantially wholly owned by the holding company—at the other extreme, companies in which the holding company controls only a bare majority of the voting power. Between these limits a third category may perhaps be formed, comprising companies in which the holding company's interest is sufficiently large to give it effective control of the subsidiary for all purposes, including winding-up, sale or amalgamation, for which purposes I believe in most countries more than a mere majority is needed: in Great Britain the necessary majority may be put at 75 per cent.

The rules which may properly be applied to the accounts of a subsidiary falling within one of these categories may not be applicable, or not applicable without modification, to a subsidiary of another class.

I think also that it would be unsafe to assume that foreign and domestic subsidiaries stand on precisely the same footing. The difference in status becomes immediately apparent when such untoward events happen as an outbreak of war or the restriction of exchange transactions.

It will, I think, be helpful therefore to consider the subject before us to-day, first in relation to domestic companies wholly (or substantially wholly) owned, and to pass later to any considerations applicable specially to the cases of companies merely controlled, and foreign companies.

The Two Sections into which the Subject is Divided.

The title of this paper was prescribed for me by the Executive Committee, and I think there is significance in the fact that of the two sections into which the subject is divided "earnings" comes first and "valuation," that is, statement of assets, takes second place.

I say it is significant because, in this country at any rate, it has been the practice to regard the statement of earnings, that is the profit and loss account of a company, as of much less importance than its balance sheet. It is true that the law which previously required only the preparation, registration and circulation of a balance sheet now directs that a profit and loss account shall be prepared, but there is no statutory obligation as there is in the case of a balance sheet, to circulate it to shareholders (or to specified descriptions of shareholders); the law is sufficiently complied with if such an account is prepared and laid before the general meeting of share-

holders. I am not lawyer enough to tell you precisely how this ceremony is performed and what its value may be, but a comparison of the requirements of British law relating to the two accounts seems to indicate that the balance sheet is viewed as an account of greater importance and of greater informative value to shareholders than the profit and loss account. When I come to the latter of the two sections into which my subject is divided, I shall say a very few words regarding the limitations of balance sheets—the matter is too large to discuss at length in a paper dealing with holding and subsidiary companies—and when the fact of these limitations is taken into account one is forced, I think, to the conclusion that insufficient stress has been laid on profit and loss accounts and that hitherto too large a share of public attention has been bestowed on statements of assets and liabilities.

PRINCIPLES INVOLVED IN THE TREATMENT OF THE EARNINGS OF HOLDING AND SUBSIDIARY COMPANIES.

I hope you will agree with me that the profit and loss account of a commercial enterprise should be so framed as to set forth with as near an approach to accuracy as possible the results of its business operations during the period to which the account relates, and that this principle should be applied to all companies, whether their business is carried on or partly carried on through subsidiary companies or not.

Wholly Owned Subsidiaries.

Wholly owned subsidiary companies, though in law separate entities, are in fact from many aspects nothing more than branches of the holding company, and I would lay down as a general principle the rule that the most correct accounting treatment of the earnings of such companies by the holding company is that which produces the same income as would be shown if the branches did not exist as separate legal entities.

I am aware that it is the practice of some holding companies to take up in their accounts the entire profits of their subsidiaries during the same period, whether declared in dividend or not, and this practice has the merit of showing clearly the aggregate of the profits earned by the organisation during the period. On the other hand the practice results in the inclusion, as an asset in the accounts of the holding company, of profits of subsidiaries which have not been and may never be distributed.

When the practice is adopted the holding company should regard as not available for dividend to its own shareholders any portion of its revenue surplus which consists of undistributed profits of subsidiaries and a note may usefully be appended to the balance sheet showing how much of the surplus is composed of such profits.

Under British law, and I suppose under the law of most other countries, the profits of a subsidiary company do not become the property of the holding company except in so far as those profits are properly declared as dividend. It is usual here to treat profits so declared as profits of the holding company in one of two ways, viz, either for the period during which the dividends are declared or for the period in respect of which they are declared.

The latter is the better alternative as it tends to bring into the same period the results of the undertaking as a whole and for the same reason it is desirable that wherever possible the financial periods of the holding company and of its subsidiaries should coincide.

Where the dividend of a subsidiary is partly derived from profits earned prior to the period in respect of which it is declared, the extent to which the dividend is so derived, at all events where it is considerable, should be disclosed in the accounts of the holding company either by adding the portion of the dividend paid by the subsidiary out of profits earned prior to the financial period to the undivided profits of the holding company at the beginning of the period, or by way of note in the accounts of the holding company.

There are cases in which only a part of the profits earned by a subsidiary company is declared in dividend and the remainder is carried forward in its accounts as undistributed. Where it is the practice of a holding company to take credit in its profit and loss account only for dividends declared by its subsidaries the result is that the earnings of the undertaking, as disclosed in the accounts of the holding company, are understated, and this fact must be recognised and must receive consideration in the light of the circumstances of each case. The commercial community, however, and I think I may say the law in this country, look on an understatement of profits with a leniency which is not extended to an over-statement. If I were called upon to give my advice it would be to the effect that a holding company should make a practice of seeing that each of its wholly owned subsidiary companies declared in dividend for each financial period the whole of the profits earned by it during that period. When, however, profits of subsidiaries reserved from distribution are made use of to supplement the dividends of later and perhaps less prosperous periods, considerations arise which have been dealt with in the remarks already made upon the treatment by a holding company of dividends paid by a subsidiary partly or wholly out of profits earned prior to the period for which its profit and loss account is made up.

Where the dividend of a subsidiary is paid (or partly paid) out of profits earned prior to the acquisition by the holding company of its interest in the subsidiary, such dividend (or part of a dividend) should be capitalised in the accounts of the holding company preferably by being written off the book cost of the shares of the subsidiary, since the revenue fund out of which the dividend is paid formed wholly or partly at the time of its acquisition part of the assets in which an interest was acquired. It is useful as a method of giving effect to this principle in the case of a wholly-owned subsidiary, to carry to a separate account in the books of the subsidiary, any profits undivided at the date of the acquisition.

It follows that where the profit and loss account of a subsidiary company is in debit at the time of the acquisition of shares in it by a holding company,

such pre-acquisition losses need not, so far as the holding company is concerned, be made good out of subsequent profits, and so far as the subsidiary is concerned, I think that in British law it is permissible for dividends to be declared out of such subsequent profits without reference to prior losses.

Where a subsidiary company is being financed by the holding company, it is sometimes the practice for the subsidiary to credit the holding company in current account with the dividends declared by the subsidiary company. I am disposed to think that it is preferable that all such dividends should be paid by the subsidiary by cheque or warrant on its bankers in the usual way, and that if this leads to a depletion of the funds of the subsidiary company to an extent requiring those funds to be supplemented, a further advance should be made by the holding company, not necessarily equal to the amount of the dividend, but regulated by the requirements of the subsidiary company.

The principles which have been suggested as applicable to profits earned and to dividends declared by subsidiary companies apply equally to the profits and dividends of companies subsidiary to subsidiary companies.

So far I have been dealing with the case of subsidiary companies which are earning profits, but important considerations apply to the case of such companies as may be incurring losses. It is in the highest degree desirable that provision shall be made for such losses out of the profits of the holding company or that they shall be added to its losses where that company is itself not earning profits, since otherwise the accounts of the holding company will not disclose, as I have said they should disclose, the results of the organisation as a whole. In considering the amount of the provisions to be made for such losses, the holding company may properly set off any undrawn profits for the same period remaining in the accounts of any other subsidiary or subsidiaries.

I have sometimes heard the opinion expressed that when taking into consideration revenue losses incurred by a subsidiary, a holding company may treat such losses as offset by appreciation which may be deemed to have arisen in the realisable value of the properties and other fixed assets of the subsidiary. Estimated appreciation in assets is no part of the trading revenue of the year and cannot be set off against trading losses in computing the earnings of the group.

An exception to the rule that a holding company should make provision for the losses of its subsidiaries may fairly be made in the case of losses incurred by a subsidiary where the book value of the holding company's interest in the subsidiary, whether in the shape of the cost of shares or debentures or of advances, has been wholly written off or provided for in the accounts of the holding company. This exception, however, covers only cases of subsidiaries which have in effect been abandoned by the holding company.

In any case in which the financial period of the subsidiary ends at a date considerably before that of the financial period of the holding company, steps should be taken to ensure that if it seems probable that the subsidiary has made a loss in the intervening period, suitable provision is made in the accounts of the holding company.

Those who have charge of the preparation or criticism of the accounts of holding companies should ascertain the extent to which, if at all, the profits of subsidiaries included in those accounts consist of profits earned otherwise than in the ordinary way of business. It is as important that abnormal profits or transfers from inner reserves of relatively material size which reach the holding company through the medium of a subsidiary should be disclosed in the accounts of the holding company as that such profits or transfers originating in the accounts of that company, should be disclosed.

There are a few other matters relating to subsidiary companies which require consideration in the preparation of the profit and loss account of a holding company.

Firstly, the profits taken up in the accounts of a holding company as having been derived from a subsidiary company sometimes take the form, or partly take the form, of interest on advances on loan or on current account, made by the holding company. It is essential that such interest shall not be included in the profits of the holding company unless there are profits of the subsidiary available for the payment of such interest. If there are no such profits, the interest should be held in suspense in the accounts of the holding company and taken credit for as profits only when there are profits of the subsidiary available for the payment of it. Where interest payable by a subsidiary is provided out of the profits of some period not concurrent or approximately concurrent with that of the profit and loss account of the holding company, the suggestions already made with regard to dividends paid by subsidiaries out of the profits of prior periods apply.

Secondly, where goods are sold to a holding company by a subsidiary at a profit, the profit on goods remaining unsold by the holding company at the date up to which its profit and loss account is prepared should be reserved in suspense in the accounts of the holding company, leaving the subsidiary to treat the profits on such sales as available for dividend.

The same principle applies to the case of goods or services supplied by a subsidiary for the purposes of capital outlay by the holding company. The holding company should charge its capital expenditure accounts only with the cost of supplies actually incurred by the subsidiary.

This principle is properly applied to all dealings between companies comprised in a group which results in profits appearing in the accounts of those companies.

Thirdly, it is of importance that where administrative or other expenses are incurred for the common benefit of two or more members of a group of companies, they should be distributed among those companies upon a system intended to be continuously

followed and designed to distribute such expenses as fairly as possible.

Fourthly, subject to any modification necessitated by differences in conditions, the accounts of subsidiaries should be prepared on lines similar to those adopted by the holding company in such matters, for example, as provision for depreciation, amortisation of leaseholds and other wasting assets, valuation of stocks and of marketable securities and provision for liabilities. In short, so far as circumstances permit, the accounts of the holding company and its subsidiaries should be drawn up as if they were the accounts of one undertaking, as indeed they are in all but the technical difference due to their existence as separate legal entities.

To give full effect to the principle it is necessary that the aggregate charge in the accounts of the holding and subsidiary companies for depreciation, amortisation of leaseholds and other wasting assets, should be the same as if those assets were owned directly by the holding company. Let me illustrate the point:

Assume the case of a subsidiary company owning nothing except a leasehold which stands on its books at an amount equal to its share capital, say, £100,000. Suppose that the shares of the subsidiary company stand on the books of the holding company at their cost of £300,000. Provision for amortisation of the leasehold should, I think, be computed on the basis of £300,000, one-third of the charge being taken up on the books of the subsidiary company and the remainder on the books of the holding company.

Most instances requiring the application of the principle will not be as simple as that of the illustration given above. For example, in many cases the premium paid by a holding company for the shares acquired in a subsidiary will be represented to some extent at all events by the acquisition of goodwill, but wherever provisions for amortisation or depreciation are based upon the book values of assets, those values should be ascertained by reference to the price paid by the holding company rather than to the figures at which the several wasting assets are standing in the books of the subsidiary company. If the point is overlooked, profits of the holding company may be overstated and opportunity will arise for abuses through the formation of subsidiary companies formed to acquire from a holding company properties at values materially less than their true cost.

Subsidiaries Controlled but not Wholly Owned.

I will now briefly consider the question how far the suggestions made in respect of wholly owned subsidiaries need to be modified in the case of a subsidiary company in which an interest is held by shareholders other than companies within the group. In such a case the dividend policy should be determined by the position of the subsidiary company and not by consideration of the interests of the holding company alone. Special care should be taken to ensure that the inter-company transactions, including the apportionment of administrative and other common expenses between the subsidiary and other companies in the group, should be effected as between independent companies. It would still be desirable for the holding company to carry in suspense any inter-company profit on the transactions with such a subsidiary which has not been realised from the standpoint of the group as a whole, but the profit so carried in suspense may fairly be limited to a proportion equal to the proportion of the holding company's interest in the subsidiary.

When losses are incurred by a subsidiary company which is not wholly owned, a point may be reached where the accumulated losses of the company exceed its share capital. In such an event it is important to remember that the outside interests cannot be called upon to bear further losses and the whole of these must be borne by the holding company itself unless it has made full provision in respect of its shareholdings and sufficient provision in respect of its advances and has abandoned the subsidiary or has made arrangements whereby the outside interests provide their share of the losses.

The comment which has been made upon the practice of taking up in the accounts of a holding company the undistributed profits of its wholly owned subsidiaries applies with even greater force to the undistributed profits of subsidiaries only partly owned.

With these modifications the principles suggested as applicable to wholly owned companies apply also to companies incompletely owned.

Foreign Subsidiaries.

The foregoing observations upon the treatment of the earnings of subsidiary companies in general are to be considered as applicable to foreign subsidiaries, but mention should be made of one or two points specially affecting subsidiary companies incorporated abroad. Holding companies should take up in their accounts the amounts of any dividends declared by such companies converted into the currency used by the holding company at a proper rate. Whether that rate should be the rate ruling at the end of the financial period, or the average of the rates ruling throughout the period, or the rate ruling on the date when the dividend is declared, are questions for consideration in the light of the peculiar circumstances of each case. It must not be forgotten, too, that in some countries at the present time the governments have fixed official rates of exchange which, however, so far as my information goes, are not always effective.

Whether such dividends should be treated as divisible profits by the holding company may also require special consideration. In the present unhappy financial condition of the world, difficulties often arise in the transmission of funds from one country to another, and where such difficulties exist it would be well that the holding company, though taking up in its accounts dividends declared, should not treat them as divisible profits but should hold them in suspense until they are received.

ACCOUNTING PRINCIPLES INVOLVED IN THE VALUATION OF HOLDINGS.

I now turn to the second of the two sections into which my subject as set forth in the title of this

paper falls, namely, the Accounting Principles involved in the Valuation of Holdings, and before proceeding to deal with this part of my subject in any detail, I desire to make some observations induced by the use of the word "valuation." If I remember aright there was an Act of Parliament relating to finance, passed in this country some years ago, with regard to which it was said, with what truth I have not concerned myself to ascertain, that it contained 27 different definitions of the word "value." In any event, it will be generally agreed, I think, that the word is susceptible of various shades of meaning. For instance, there are things which have a sentimental value, there are things which are of no value except to the person to whom they belong, there are things the value of which differs materially as the result of varying conditions, there are values of things as "going concerns" and there are "break-up" values.

I think, however, that to the ordinary person not specially versed in the technicalities of business, the word "value" as applied to a thing means what that thing could be sold for.

In this sense the word "valuation" is not applicable to some at least of the classes of assets which figure in a great proportion of balance sheets.

I think it of importance that it should be realised how misconceived is the notion, all too common, that the balance sheet of a commercial undertaking purports to set forth the "value" of the assets of that undertaking.

In so far as those assets are what are generally known as fixed assets, to endeavour to set forth in a balance sheet their sale value would be irrelevant even if it were not also impracticable. By fixed assets I mean assets acquired and intended to be retained in relative permanence for the purpose of carrying on the business of the undertaking and not for the purpose of realisation at a profit. It must not be forgotten that "valuations" are estimates which even although they are made, as they often are, by persons of the highest skill and integrity, remain nothing more than estimates. It is only possible to ascertain value in the sense in which I have suggested that it is generally understood, by entering into a good contract for sale with a solvent party. I know how useful it would be in practice to business men and to investors if, from an intelligent perusal of the balance sheet of a commercial undertaking, they could obtain information as to the aggregate realisable value of the undertaking—what is sometimes called "net worth"; but balance sheets do not purport to give such information, and the plea of accountants that balance sheets should not be regarded as doing so is no mere shabby evasion.

That plea rests not only on the fact that balance sheets are not designed to give such information but also on the equally important fact that in a large proportion of cases values, in the sense which I have attributed to the word, are not ascertainable, so far, at all events as fixed assets are concerned.

The interest of a holding company in its subsidiary normally falls into the category of fixed assets as having been acquired not for resale but to be retained for the purpose of carrying on the business of the undertaking, and as such should be stated on the basis of cost, it being understood first, that due allowance is made in the accounts of the subsidiary company for the maintenance of its fixed assets; second, that any trading losses of the subsidiary are provided for in the accounts of the holding company; and third, that any profits of the subsidiary brought into the accounts of the holding company, either by way of dividend or otherwise, which were earned by the subsidiary prior to its acquisition by the holding company, are deducted in computing cost.

The fact, however, must not be lost sight of that the investing public is disposed to look upon shares and debentures in a light different from that in which they regard such fixed assets as goodwill, land, buildings, plant, machinery and the like. They realise, I think, that directors and auditors are not usually in a position to form an opinion of the realisable value of such assets as goodwill, land, &c., and that, if they could, it would not be relevant so long as there was no intention to dispose of them, but they are apt to take a different view regarding shares and debentures, whether they represent interests in subsidiary companies or not.

In the case of wholly owned subsidiaries, since the holding company's interest in effect represents the ownership of the assets of the subsidiary company (which may include goodwill, land, buildings and the like) the distinction is quite unfounded. Those responsible for the accounting of a holding company are not called upon to consider or attempt to set forth the realisable values of the holdings in subsidiary companies.

Holdings in partially owned subsidiaries may stand on a footing different from that of wholly owned companies, particularly if the outstanding interest is large and reliable market quotations are available in respect thereof. But even in this case a quotation which may properly be deemed a measure of the value of a small number of shares may not be equally indicative of the true value of a majority holding.

FORMS OF ACCOUNTS.

At the risk of going somewhat beyond the subject assigned to me, I should like to say a few words on the subject of the form in which the relevant facts in relation to subsidiary companies can best be communicated to the shareholders of the holding company.

In any attempt to deal with this question I think that two facts should be borne in mind. The first is that where investments in subsidiary companies are of material importance reasonable information in regard to the earnings, assets and liabilities of those companies is as essential to a proper understanding of the financial position of the holding company as information in regard to the earnings, assets and liabilities of the holding company itself. The second is that the character of subsidiary companies and the nature and extent of the interest of the holding company therein vary to so great an extent that no uniform rule can be laid down which could be expected to fit every variety of case.

Various forms of account may be suited to various conditions, but I will name a few which suggest themselves to me.

The best form to be adopted is, I think, the presentation of the statutory balance sheet and accounts of the holding company, accompanied by the accounts of subsidiary and sub-subsidiary companies, with an explanation of the manner in which, and the extent to which the profits of the subsidiaries have been brought into the accounts of the holding company.

There are cases, however, in which the number of subsidiaries owned or partly owned by a holding company is so large as to make this plan impracticable, and in such instances it is not unusual to supplement the statutory accounts of the holding company by combined statements of earnings and of assets and liabilities of the holding company and of its subsidiaries and sub-subsidiaries. This form has the advantage of presenting a comprehensive view of the facts but is open to serious objection, so far as the statement of assets and liabilities is concerned, in that the inference apparently to be drawn from the form is that the creditors, secured and unsecured, of the several companies forming the combination, have a common fund, namely, the aggregate assets of the combination, to look to for the payment of their debts, which is not the fact. A further serious objection exists where the subsidiaries, or some of them, are not wholly owned. It is necessary in such cases, when preparing combined statements, to deduct from the aggregate earnings a sum to represent the share of the outside interests in those earnings and to set up a liability upon the combined statement of assets and liabilities to represent the interest of outside shareholders. Such an account should not be considered as a substitute for the statutory balance sheet which should be drawn up so as to show the financial position of the holding company as a legal entity.

Another plan which is sometimes adopted, and which has much to recommend it, is to include in the directors' report a statement showing the aggregate profits of the subsidiaries and the proportion of them which has been brought into the accounts of the holding company. It is useful to add to such a statement a note of the amount of aggregate profits or losses since the date of acquisition carried forward in the accounts of the subsidiaries. Such a plan, though giving useful information in regard to earnings, is deficient as supplying no information in regard to the assets and liabilities of the subsidiaries, a fact which may be of great importance, particularly if any of the subsidiaries have heavy secured liabilities outstanding. A modification, or perhaps I should say an attenuation, of this last-mentioned plan is to add a note in the balance sheet of the holding company below the entry of its investments in its subsidiary or subsidiaries, to the effect that the net earnings of those companies for the financial period represent a specified percentage per annum on book value.

AUDIT OF THE ACCOUNTS OF HOLDING AND SUBSIDIARY COMPANIES.

I have already taken the risk of transgressing the limits of my subject, but I must beg to be forgiven for incurring the risk again. I should like to make a very brief reference to the audit of the accounts of holding and subsidiary companies. It is usually advisable that the same auditors should be employed to audit the accounts of all companies within a group, and, indeed, there have been instances in which, if the same auditors had been employed to audit the accounts of all the grouped companies, irregular and perhaps improper transactions might have come to light at an early stage and much loss and trouble have been saved. There may, however, be difficulties or inconveniences owing to special conditions in making such an arrangement, but where the auditors of a holding company are not also auditors of the subsidiary companies or at all events of those of them which are of material importance, they should have access to the detailed accounts of the subsidiary companies and should be empowered to call for full explanations from the directors and auditors of those companies of any matters in the accounts which they may consider require explanation.

CONCLUSION.

I hope that the foregoing remarks will not be without their value if only as a means of stimulating discussion of a subject of importance to the financial world. It is, too, a subject of growing importance in these times of large aggregations of capital in companies no small proportion of the activities of which is carried on through the medium of subsidiary companies. The fact that a part, sometimes the greater part, of the operations of a large commercial undertaking is carried on through subsidiary companies tends, where some such procedure as that suggested above is not adopted, to the concealment of facts which it is material that those interested in the organisation should know.

The practice of the formation of subsidiary companies and, I may add, particularly the formation of sub-subsidiaries, permits the carrying out of a policy of secrecy to a degree which would not be possible if the operations of an organisation were carried on through a single company.

The degree of secrecy which may be justifiable in the conduct of a business carried on by partners, all of whom are usually in frequent contact and are entitled to full information regarding the affairs of the firm (if they have not by express argeement waived their right to it) is out of place in a company the shareholders of which can look only to the accounts and the report (usually meagre enough in character) issued by the directors, for the particulars necessary to enable them to take an intelligent interest in the undertaking of which they are the owners. In addition to such opportunities of obtaining information they can, of course, attend the periodical meetings of the company, but any inquiries they may have to make must almost of necessity be based upon the information contained

in the accounts and report supplemented possibly by a verbal statement made by the chairman.

I venture, then, in the case of holding and subsidiary companies, to put in a plea for increased publicity. I am aware that a policy of secrecy is often defended on the ground of the necessity for concealing facts the knowledge of which might be of value to competitors. I think it is quite possible to place too much emphasis upon the risk of benefiting rivals as the result of the publication of particulars useful to shareholders. Trade rivals are, after all, not dependent mainly on the reports and accounts published by the directors of a company for information as to its activities and their results, and the omission to disclose what may prove to be material facts may have serious results for the shareholders.

The whole question is so important and so fraught with difficulty that it deserves the careful and constant attention of the organised profession of accountancy throughout the world.

In the United States of America the profession has made substantial progress in dealing with it, greatly aided by the New York Stock Exchange which has insisted on adequate disclosure in one form or another in relation to subsidiary companies. In Germany the newly-formed Institute will, I am sure, approach the question in the broad spirit that has marked its initial activities. In Great Britain, as I have indicated, the practice is not entirely satisfactory and is bound to receive further consideration, and I should be quite prepared to learn that the same may be said of other countries represented at this international gathering.

The solution of the problems is not to be found in legislation, though laws more helpful than those now in force in this country could doubtless be devised. But laws cannot usefully set a standard of conduct such as directors and auditors truly concerned for the welfare of shareholders would wish to adopt, but only a minimum standard to which even the least conscientious must adhere or be subject to penalties. Neither directors nor auditors should be satisfied with bare compliance with such statutes. Nor should the accountant be content merely to adopt and follow public opinion; in a field in which his experience gives him special competence he should aim to lead public opinion in the right direction.

To achieve our full measure of usefulness we must combine honesty, independence and care in discharging our responsibilities with a broad view of the limits of those responsibilities and a willingness to extend those limits to meet the changing needs of business and of the investing public.

Discussion on Sir Albert Wyon's Paper.

Mr. MAURICE E. PELOUBET, C.P.A. (U.S.A.), said it was a bold thing for a pupil to venture to discuss the work of his teacher. It was his good fortune to be for several years associated, both in the United States and England, with the firm of which Sir Albert Wyon was the head. Sir Albert seemed to consider that the ideal situation in the accounts of a holding company was where the books of the holding company itself expressed correctly the results of the entire enterprise. It seemed to him that in the paper under discussion an attempt was being made to write into the books of the holding company what was essentially a consolidated income and surplus account. While this was a most interesting suggestion, and possibly practicable where only a few subsidiaries with a relatively simple financial structure were concerned, he was somewhat doubtful of its theoretical soundness or practical desirability where numbers of subsidiaries with interlocking stock ownerships and organised in different countries or under different legal jurisdictions were in question. With one exception, all of the advantages of the method proposed would be gained by means of properly constructed consolidated accounts. The one exception was that the legal claim which any particular creditor or group of creditors had on any particular asset was not shown. Whether it was possible, no matter how the underlying accounts were stated, to draw up a balance sheet of a large enterprise of complicated financial structure so that the same accounts gave the creditors of individual companies and the shareholders of the holding company the information they both needed was a highly debatable question. In the paper under discussion it was suggested that, in order to show on the books of the holding company the results of the consolidated enterprise, wholly owned subsidiaries should declare in dividends 100 per cent. of the profits each year. It was true that, with the exception of providing for losses, this would show a total profit which would be the correct figure for the consolidated enterprise providing all subsidiaries were 100 per cent. owned. However, it was most unlikely that all the subsidiaries would be in a position to pay such dividends in cash. To overcome these difficulties it was suggested that the dividend be paid in cash and the amount which would have to be turned back to the subsidiaries for reinvestment, either in fixed or current assets, should be treated as an advance by the holding company to the subsidiary. It was hard to see how this somewhat artificial method of procedure could fail to create difficulties of several sorts. In the first place, it would be very difficult for the shareholders or creditors of the holding company to distinguish between those advances or those parts of advances which represented the current assets, from those advances which represented profits reinvested in subsidiaries, and which could not be repaid so long as the subsidiary continued to operate. There also seemed to be a possibility of abuse present in the ability of some companies to pay more currently to the parent or holding company than their profits declared as dividends. A correctly drawn-up consolidated balance sheet and income account met all these objections. If all completely owned subsidiaries should declare their total annual profits in dividends, no discretion would be left to the accountant when deciding on what completely owned companies should be included in the holding company's accounts. Under the ordinary methods of consolidation, this problem divided itself into two contrasting questions: first, what companies should be consolidated regardless of extent of ownership and, second, what percentage of ownership was a proper basis for consolidation. Although it might not be the orthodox opinion it would seem that there might be cases where 100 per cent. owned companies should not be consolidated. Where a company was owned 100 per cent., but where the business was not a true part of the economic unit, and was neither directly nor indirectly under the parent company's management, the shares of that company should be carried as an investment. As to percentage in consolidation, there was wide latitude. About the only valid argument for not consolidating a company which was clearly a part of the economic unit, and was over 51 per cent. owned, was the inconvenience and difficulty of handling large items of minority interest. In the United States there seemed to be general agreement that ownership of 75 per cent. was a fair minimum for justifying consolidation, which, view, however, was not shared by the United States income tax authorities who now required ownership of 95 per cent. It was interesting to see that the British practice in regard to percentage required for consolidation was substantially the same as that existing in the United States. Under the plan proposed for holding company accounts, the interest of the holding company in the profits of partially owned

subsidiaries would be shown only to the extent of dividends declared by the subsidiary on the basis of an independent company and the usual elimination of unrealised inter-company profits would be made, although by another method. The effect would be to show in the holding company's accounts all profits of completely owned companies, but only those payable in cash where the ownership was less than complete. He thought they were all in complete agreement with Sir Albert so far as the principles of correct and honest disclosure of all pertinent facts to all parties entitled to such information was concerned. Whether they would all see eye to eye with him in matters of procedure was another matter, but none of them would disagree with the basic principles brought out in the paper.

Mr. P. KLIJNVELD (Holland) said that his remarks were intended as a comment on a few questions which he hoped that Sir Albert, who had proved that he commanded the subject, would answer. Excepting with respect to life assurance companies, there were in Holland up to the present moment no legal regulations with regard to the composition of the profit and loss account, and the law only gave a few rules as to the publication of balance sheets, stating how the assets should there be mentioned, and also that the balance sheet must be accompanied by an explanatory memorandum, signed by the management and directors, stating on what basis the assets were valued. One of the stipulations was that participations in other companies should be separately mentioned in one item in the balance sheet, in combination with the advances in relation to those participations. The Dutch law, however, did not know a regulation such as that of the English Companies Act of 1929 with regard to the profits and losses of subsidiary companies. The regulations which Sir Albert would like to see extended might represent a great advantage for the shareholders as compared with the countries in which there were no legal regulations as to the publication of profits and losses. If, however, a holding company were to go too far in their specifications of profits and losses, there would be a danger that it would thereby inform the competitors, probably to the detriment of the concern. In his opinion, losses suffered by a subsidiary company should be expressed in the holding company by discounting the loss in the valuation of their interests, or, if the holding company could no longer do that, then in the valuation of its share holdings. He was of opinion that one could not go so far as to state, in the profit and loss account of the holding company, the exact amounts with the names of the subsidiary companies. He would therefore like to ask Sir Albert whether he did not consider it sufficient that the English auditor in submitting a full statement should be compelled, if the company had not taken sufficiently into account the losses in participations, to make a statement to that effect. They need only glance at the events of the last few years to appreciate what a gigantic risk could lurk in the combination of an industrial operating company and a bank. Would not a great deal be achieved if an international regulation could be made with regard to that? Present economic difficulties had led great concerns to expand their interests in foreign countries in order to face international difficulties. In his paper Sir Albert had further stated that the auditor of the holding company should in fact be the auditor of all the subsidiary companies, and he agreed to that, but that was not always possible in practice. There must, however, be contact between the various auditors of the subsidiary companies and those of the holding company by means of the auditors of the subsidiary companies carrying out their work according to a uniform programme or plan approved by the auditor of the holding company, and that the auditors of the subsidiaries should send in their reports to the auditor of the holding company, in which reports the points which the auditor of the holding company had asked for should be explained.

Mr. L. W. FARROW, F.C.A., said that public interest in the subject of the lecture had increased materially during the last few years, because the structures of our large industrial combines had been built up on the basis of holding and subsidiary companies. He did not consider that this tendency had been a matter of intention, but rather that the rationalisation of industries and the combination of several small units into large units had led through one cause or another to the retention of the individual companies comprising those combines. Holding and subsidiary companies had become a permanent feature of industrial finance in this and other countries, and it was therefore of paramount importance that everything possible should be done to allay the suspicions which now existed, and to avoid a repetition of those black spots in this method of company finance. If the accounting principles which Sir Albert Wyon had indicated were followed, he was certain that all would be well with the future of holding and subsidiary companies. He agreed that the only satisfactory method of dealing with profits of subsidiary companies, especially those which were wholly owned, was to bring into the profits of the holding company the whole of the profits earned by the group—in other words, to treat the subsidiary companies as though they were branches of the holding company. Should there be debenture holdings or share holdings in a subsidiary company not held by the parent company, the question arose as to whether part of the profits earned, especially in good years, should be retained in that subsidiary company to strengthen its resources. If this should be decided upon, he still considered that the amounts so retained should be brought into the profits of the holding company, but earmarked as not being available for dividend to the shareholders of the holding company until actually declared by way of dividend by the subsidiary company. On the question of losses, he thought it essential that the holding company should either provide for losses made in subsidiary companies by deducting such losses from the earnings of other subsidiary companies in the profit and loss account and deducting a similar reserve from the value of the shares in the subsidiary companies, or by passing credit notes to the subsidiary companies equal to the losses sustained. One of the most difficult questions in auditing the accounts of holding companies was in regard to the valuation of holdings in subsidiary companies in the balance sheet of the holding company. A holding company might own several subsidiary companies all making perhaps moderate profits, but whose plants were not fully occupied. By transferring the output from one or more subsidiary companies to the rest of the group, and closing down the plants of such companies, materially increased profits might result to the group. The question then arose as to the values of the holdings in those companies whose plants had been closed down. His opinion was that if the total value of the subsidiary companies before the transfer was a fair one, then the directors of the holding company were justified in writing down the holdings of the subsidiary companies whose plants had closed, to the scrap value of the plants, and adding the differences to the values of the remaining subsidiary companies. There was one suggestion which Sir Albert Wyon made with which he was unable to agree, namely, the advisability that the same auditors should be employed to audit the accounts of all companies within a group. If his alternative suggestion were acted upon (with which he agreed), namely, that the auditors of the holding company should have access to the detailed accounts of the subsidiary companies, and should be empowered to call for full explanations from the directors and auditors of those companies of any matters in the accounts which they considered required explanation, adequate protection would be given not only to the auditors of the holding company, but to the investing public. (Applause.)

Mr. CHARLES E. FLETCHER, F.C.A., said that as far as legislation touching accounts was concerned, there would always be in the world a certain number of individuals desirous of publishing accounts which did not reflect the true position, but because there were a few such individuals it did not seem reasonable that honest traders should be hampered by legislation devised to defeat the wiles of a few dishonest individuals. The problem was one of common sense, and it seemed obvious that if an auditor felt that a balance sheet, whether that of a

holding company or that of any other company, did not give reasonable disclosure to the shareholders, it was his duty to amplify his report in such a way as to bring to the notice of the shareholders the information not disclosed by the accounts. Sir Albert, in his remarks on the valuation of holdings, made some very pertinent observations which he thoroughly endorsed, particularly his reference to the misconceived notion that the balance sheet of a commercial undertaking purports to set forth the value of the assets. He was strongly of the opinion that shares in subsidiary companies were just as much fixed assets as land, buildings, plant and machinery, and if that opinion was wrong he could not conceive what an auditor's position was with regard to subsidiary companies. Special circumstances might arise when it was necessary to consider the value of holdings in subsidiary companies, but in the ordinary course of events, provided that the holding company maintained its capital in the subsidiaries intact, and showed how it dealt with their profits and losses, directors or auditors could not be expected to go into the question of values either for the purposes of sales or from an earning-capacity point of view. With regard to the treatment of the earnings of subsidiary companies, he was strongly of opinion that the most accurate picture was presented where all profits and losses were brought in, provided always it was clearly shown on the face of the accounts that the accounts had been drawn up on that principle, and that the accounts contained the profits of separate legal entities, which, not having been paid over as dividends, had not become legally the property of the holding company. If only dividends from subsidiaries were brought in, an inaccurate picture would be presented of the earnings of the holding company and its subsidiaries. The inclusion in the profit and loss account of all profits and losses of subsidiaries had another great virtue in that it precluded the directors from hoarding up profits from subsidiaries in good years, and bringing them to the credit of profit and loss account in lean years without disclosing the position to their shareholders. In conclusion, he wished to endorse Sir Albert Wyon's statement that neither directors nor auditors should be satisfied with bare compliance with Statutory provisions. (Applause.)

Mr. RICHARD A. WITTY, F.S.A.A., said he proposed to deal with two broad principles enunciated by Sir Albert Wyon. He wished in the first place to emphasise and endorse his contention that insufficient stress had been laid on the profit and loss account, and that hitherto too large a measure of public attention had been bestowed upon statements of assets and liabilities, because it could be said that every argument used by Sir Albert pointed to the necessity of their revising their ideas as to the relative importance of balance sheets and profit and loss accounts. That applied particularly in the case of profit and loss accounts of holding companies. The other broad principle was his concluding remarks that the solution of those principles was not to be found in legislation, but rather in the spirit in which directors of companies and auditors approached those problems. They all knew that it was impossible to protect the fool against his own folly, but the Macmillan Committee had specially stated that the mere fact that one could not protect a fool from his own folly was no reason why they should not give the prudent man guidance. That, it seemed to him, was exactly what Sir Albert had been doing in his paper, and if he could succeed in persuading the practising accountants of this country to approach those problems in that spirit he would earn the gratitude of every reasonable shareholder. They might go further and say that if all practising accountants would follow that principle, and would remember the phrase, "Give the prudent man guidance," it would be accepted as a far better epitome of the general duty of an auditor than all the watch-dogs and bloodhounds that had ever stalked through the pages of any textbook. (Laughter and applause.)

Mons. M. PIMENTEL (Holland) said it was not quite clear to him what Sir Albert meant with regard to the payment of dividends by the subsidiary company, when he pointed out that it was desirable for the subsidiary company which was financed by the holding company to pay the dividend by cheque or warrant on its bankers, and that the depleted funds of the subsidiary should be supplemented by the holding company. He failed to see the necessity of settling in that way. In his opinion, it was advisable that when the holding company financed the subsidiary and the two companies consequently had current accounts with each other, either directly or indirectly via other subsidiaries, to stipulate that as soon as the subsidiary had a balance in hand it should be remitted to the holding company, whilst the payment of dividend could be settled in current account, assuming that the holding company held all the shares of the subsidiary. Owing to the monetary difficulties in the various countries, the greatest prudence under the present circumstances had to be exercised by the holding company in declaring its dividend. Subsidiary companies might make reasonable profits which would result in a dividend being paid to the holding company, but when the financial position of such a subsidiary was examined, it might be found that the profit had really, wholly or partially, come about through depreciation of currency, and that the working results of the subsidiary would actually show a loss. In such a case no dividend should be paid, as the payment would be a draw on the holding company's own capital. Not only should there be no dividend declared, but the so-called profit or dividend of the subsidiary should not appear as a profit in the books of the holding company. He differed from Sir Albert in respect of those subsidiaries which were not audited by the accountant of the holding company. In his opinion, the accountant would have to depend on the reports published by the auditors of the subsidiaries, providing of course such accountants were of good repute. Moreover, it often occurred that the holding company had an audit department, in which case the accountant who had to certify the balance sheet and profit and loss account of the holding company might likewise depend on the reports issued by that audit department. (Applause.)

Sir BASIL E. MAYHEW, K.B.E., F.C.A., said the problems presented by the accounts of holding and subsidiary companies were not peculiar to any one country. The views expressed by Sir Albert Wyon fairly represented the general opinion of the profession in the British Isles, but, whether they agreed with them or not, he felt sure that his concluding remarks would be endorsed by every qualified accountant. Sir Albert mentioned that it was the practice of some holding companies to take up in their accounts the entire profits of their subsidiaries whether declared in dividend or not. There was no doubt it could be done, but there was no uniformity on the point and opinion amongst accountants in this country was by no means unanimous. It was true that the profits of a subsidiary company did not become a legal debt to the parent company until declared as dividend, and two points had to be emphasised in that connection. Firstly, the holding company must not itself declare a dividend out of such profits until they had been declared as dividends by the subsidiary company; and, secondly, the method of describing in the balance sheet the profits not yet declared as dividends, must be carefully considered. If, between the date of the balance sheet and the issue of the accounts the dividend was declared by the subsidiary, then he thought the asset might be treated as a current asset. On the other hand, where it was known that such profits, or part of such profits, could not or would not be declared in the form of dividends, most careful consideration would have to be given to the manner in which that asset was dealt with in the balance sheet. Another question which might arise in connection with that method of treating profits of subsidiary companies was the correct amount to be brought into the holding company's profit and loss account where a subsidiary had allocated a proportion of its profits for the year to a free reserve. He thought it was quite in order for the holding company to credit the full amount of the profits before the transfer to reserve, provided it was made perfectly clear by wording in the profit and loss account and balance sheet of the holding company what had been done. To do otherwise would be to defeat

what Sir Albert had described as "the merit of showing clearly the aggregate of the profits earned by the organisation during the period." He was a strong supporter of the policy of publishing a consolidated balance sheet and profit and loss account of the group, although he realised the practical difficulties in a great number of cases. (Cheers.)

Mr. THOMAS KEENS, F.S.A.A., said the importance of the subject could not be over estimated. The difficulties were best expressed in the words of Sir Albert: "The attempts of legislatures to deal with the subject have been few and ineffective." The urgency of the question was shown by the feeling of the national Press and the statements of those properly regarded as leaders in the accountancy profession. With regard to the conclusions of the paper, he desired to call attention to two points only. The first was in connection with the general questions affecting all companies having subsidiaries and sub-subsidiaries. There were two points of view—one, that of the practising accountant, the other that of a director of an industrial undertaking having subsidiaries and sub-subsidiaries. Sir Albert said that the most correct accounting treatment was to bring in all earnings as if it were one company. This method, however, resulted in the inclusion of profits which had not been and might never be distributed. Again, under British law, the profits of a subsidiary did not become the property of the holding company except so far as those profits were properly declared as dividends. This was undoubtedly so, and therefore he submitted that anything more in the profit and loss account raised a partly artificial state of affairs, and led to a number of conclusions which to his mind were unsatisfactory. It was the financial policy in a well-managed industrial undertaking to build up adequate reserves for extending its business without recourse to more than temporary borrowing, and that the policy of the subsidiaries should be on the same lines. That policy was impossible if the subsidiary declared the whole of its profits as dividend, and the holding company made loans to the subsidiary if necessary to enable it to be done. There was the further objection that the balance of profit on the balance sheet would not be the profit available for dividend. In general, he submitted that the conclusions of the Committee of the Society of Incorporated Accountants and Auditors on this question met the necessities of the case. The other point of interest to the profession with which he desired to deal was the desirability of the same auditors being employed to audit the accounts of the holding company and all its subsidiaries and sub-subsidiaries. Theoretically that might be so, and he had practical acquaintance with the happenings where different auditors had been successfully kept apart where an examination of all the accounts together would have disclosed that the game was up. But many of the holding companies were so huge, and the number of subsidiaries so large, that the amount of devolution which the auditor must do was so great that he was perfectly certain the same object could be achieved by the alternative suggestion which was made, without dispossession of another professional accountant. (Applause.)

Mr. BRIAN MANNING, F.C.A., said that many of the problems which subsidiary companies presented arose largely from abuse. During past and recent years there had been cases where serious frauds had been perpetrated through that medium. But hard cases made bad law, and it was worth while, before throwing too much blame, in this country, on the Companies Acts, to consider whether any practical legislation could provide a complete remedy. Personally, he held the view that public opinion and the ministrations of members of the accountancy profession could provide greater safeguards than rigid and cramping legislation, which might restrict legitimate enterprise. He wondered, when Sir Albert Wyon dealt with wholly owned subsidiaries, though in law separate entities, as being from many aspects nothing more than branches of the holding company, whether he would apply that principle whatever the relation of the activity of the subsidiary company to the holding company. So many subsidiary companies were complete entities in themselves that the holding company was little different from a body of shareholders, and present methods of accounting provided so well for the treatment of dividends of subsidiary companies that he wondered if it might in many cases be inadvisable to incorporate the profits in the accounts of the holding company, however segregated. On the other hand, the submission of a memorandum consolidated profit and loss account was always to be recommended.

Mr. HENRY MORGAN, F.S.A.A., said that he wished first to associate himself with the references which had been made to Sir Gilbert Garnsey. The course of events had brought him into very close touch with Sir Gilbert, and it had been his privilege on many occasions to discuss with him the knotty problem of holding and subsidiary companies. He knew that Sir Gilbert's views upon the subject were identical with those put forward by Sir Albert Wyon. It must be quite obvious to every accountant that, if the principles put forward by Sir Albert were not given effect to in preparing the accounts of holding companies, those accounts could not be true and accurate. Three questions arose in his mind: firstly, to what extent were those principles adhered to in actual practice? Secondly, should they be adhered to? Thirdly, if they were not adhered to, what was an auditor's duty? He agreed entirely with the views expressed by Mr. Peloubet. There was no doubt that in the case of holding and subsidiary companies the investing public did view their accounts with a great deal of suspicion. Was that to be wondered at? He would refer them to Sir Albert's observations on page 2 of his paper: "The particulars required by the Act to be disclosed are of so general and vague a character as to be quite insufficient to supply shareholders with the information necessary." The most usual statement to comply with sect. 126 of the Act was to the effect that the profits of subsidiary companies had been included to the extent of dividends declared. Such a statement could not give effect to the views of most of the speakers who had expressed their opinions that day. The Act required disclosures as to how profits of subsidiary companies had been dealt with. In addition to the dividends declared, substantial sums might have been placed to reserve; large sums might still be carried forward in the accounts of the subsidiary companies, and those dividends might to a large extent have been the result of profits earned in a year prior to that of the accounts under review. Unless there was an alteration in practice, it must be quite obvious that the principles advocated by Sir Albert and assented to by other speakers would not be given effect to. He hoped that the views expressed that day might have the result of so improving practice in regard to the accounts of public companies that a great deal of the suspicion which at present attached to them would be removed. (Applause.)

Mr. W. A. STAUB, C.P.A. (U.S.A.), said that he brought to the Congress the greetings and good wishes of his own Society, the New York State Society of Certified Public Accountants. It was interesting to mention that, in addition to the two national bodies, each of the 48 different States had its own body of accountants. The use of consolidated statements had become very general in the United States, and he had been reminded by the presence of Sir Arthur Lowes Dickinson that approximately a generation ago, when he had been in active practice in the United States, Sir Arthur had given considerable formation and direction to American practice in the preparation of consolidated statements. The use of such statements for a long time, and increasingly so of late, had displaced the use of separate statements, either balance sheets or profit and loss accounts, in the published reports of large companies with a considerable number of subsidiaries. Some American public utility companies had several hundred subsidiaries, and that seemed to be the practical method of presentation, and was still so regarded. Latterly it had become recognised that there was certain value in presenting in addition a separate statement of the holding company. In the legislation enacted since President Roosevelt had taken up the matter of the protection of the investor, the Federal Securities Act imposed

very heavy responsibilities upon accountants in the United States. The question of the degree of consolidation was always one of the big problems. At first the Federal Trade Commission had ruled that all subsidiary companies owned to the extent of 51 per cent. or more should be included, but it had been recognised in subsequent discussion that that was not a desirable compulsory requirement, and at the last discussion the matter stood that subsidiary companies owned to the extent of 75 per cent. should normally be included. Those between 50 per cent. and 75 per cent. should be included or omitted according to whether disclosure would be informative or the reverse.

Mons. H. SENECHAL (France) said that the question of holding and subsidiary companies could be extended from the fiscal point of view. Whether one liked it or not, the intervention of the fiscal authorities of every country could not be avoided in relations between holding and subsidiary companies. One concrete case would explain how the difficulties were arising. Suppose an American factory decided to create in France a subsidiary company to sell its products. The American holding could fix the selling prices in such a manner that it would be impossible for the subsidiary company to make any profit in any way, or to pay any trading income tax. The question was foreseen in the French law of 1872, since which time four or five other laws had been made on this subject, the most recent being in the month of May last. Briefly, in the case here above mentioned, the French fiscal authorities did not accept the profit and loss account as it appeared in the books of the subsidiary company. They requested the company to submit a certified balance sheet of the holding company, and the trading income was calculated in proportion to the combined results revealed by the holding company's balance sheet, generally taking into consideration the average percentage of gross or net profit on the full turnover of the company, and applying that average percentage to the turnover made by the subsidiary company. Usually, the request of the fiscal authorities was declined by the holding company, in which event the fiscal authorities assessed the amount arbitrarily and the matter was then referred to the Court. In Italy, the same difficulties arose. In France, the difficulties had been stopped for the present, after diplomatic steps, but they were only postponed; they were not solved. He would submit that the International Congress Committee should get in touch with the Secretary-General of the League of Nations with a view to ascertaining the actual position as regards the question, and deciding how and to what extent certified public accountants in every country could cope with this problem in the best possible manner for the promotion of world commerce. (Cheers.)

Herr Dr. G. F. HORN (Germany) said that shareholders had the right to know everything as far as possible in connection with their companies. He considered that the problem was concentrated in the paper in two sentences. The first was the reference to the necessity for entering into a good contract for sale, and the second was the statement that the solution of the problem was not to be found in legislation, but in the responsibility of the auditors. In Germany an effort had been made to deal with the problem in the best possible way, and the Companies Act there was an attempt to give shareholders what they wanted and to fix the responsibilities of the accountants. Having had experience of that law, they were able to say that it was a good one. (Applause.)

Sir Albert Wyon's Reply.

Sir ALBERT WYON, replying to the discussion, thanked the speakers for the kind way in which they had spoken of his efforts to throw some light upon that difficult problem. He knew there were many controversial points. Referring to what Mr. Peloubet said as to consolidated accounts, it was not his (Sir Albert's) suggestion that the assets and liabilities of subsidiary companies should be taken up in the books of the holding company. That, as he said, was practically impossible, and would be of no value if it could be done. He directed his suggestions to the inclusion in the accounts of the holding company of what were practically the earnings of the group of which the holding company was the head. He did not think that the preparation of consolidated accounts could take the place of the proper promulgation of the accounts of the holding company. It was out of the balances shown by the holding company that shareholders received their dividend, not out of the surplus shown by any consolidated accounts, and therefore he thought it essential that the consolidated accounts should not be regarded as taking the place of properly drawn up accounts of holding companies. Then Mr. Klijnveld referred to the accounts of life assurance companies. They knew that for years past it had been the practice of life assurance companies for obvious reasons to consolidate their accounts, viz, the amounts of premiums, claims, expenses and assets. It was the practice of insurance companies to advertise very widely their income and their total assets. It was therefore to the advantage of such companies to present as large totals as they possibly could, and it was the practice of many insurance companies in this country, and he believed abroad, to present what were in fact nothing more than consolidated accounts. Happily, there had been within the last two or three years a change in that respect in this country, and all insurance companies now published not only a consolidated account, but also statutory accounts in which interests in subsidiary companies were shown as investments, as he thought they should be. Mr. Klijnveld had stated that in his opinion losses made by subsidiary companies should be provided for in the accounts of the holding company, and that the law in Holland required that to be done. If so, he thought it was a very good law, and he should like to see it extended to other countries. One or two speakers made reference to the auditing of the accounts of holding companies and subsidiary companies respectively. He fully agreed with what Mr. Keens said, that it was not always desirable that the services of the auditors of subsidiary companies, when those companies came to be absorbed in a larger group, should be dispensed with. There were many reasons for retaining the services of the auditors in those circumstances, but he thought the suggestion he made at the close of his paper, that the auditors of the holding company should have facilities to enable them to make detailed inquiries of the auditors of the subsidiary companies, should wherever possible be adopted. (Hear, hear.) He did not agree with the suggestion of one speaker that the mere certificate of the auditor of a subsidiary company should be regarded as sufficient by the auditor of the holding company without further inquiry. They could all envisage circumstances in which details would be of the utmost value to the auditors of the holding company. One speaker referred to his suggestion that it was wise that the whole of the profits of a wholly-owned subsidiary company should be declared by that company in dividends, and so appear in the accounts of the holding company. That was not much more than a variation of the method described by Mr. Fletcher. He saw no objection to a subsidiary company declaring the whole of its profits in dividend, and actually paying them over to the holding company. He preferred to see the finances of a group in one balance sheet only—that of the holding company. He liked to see any funds required by subsidiaries provided by the holding company and those provisions being made altogether independent of what happened to the profits earned by the subsidiary companies. He did not think that the needs of the subsidiary companies ought to be measured by the dividends which they might declare. In the same way he liked to see the free reserves—not reserves for expenses, depreciation or amortisation—in the accounts of the holding company so that they could be laid before the shareholders. In conclusion, he desired to confirm what Mr. Morgan said, that his views on holding companies were identical with those of his late and much lamented partner, Sir Gilbert Garnsey. They had had many talks on the subject, and their views had slowly crystallised. (Applause).

BANQUET IN THE GUILDHALL.

On Wednesday, July 19th, a Banquet in connection with the Congress was held in the Guildhall, under the Chairmanship of Lord Plender. His Royal Highness The Prince George was the principal guest, and amongst those present were :—

The Archbishop of York, the Marquis of Reading, Earl Stanhope, the Earl of Stradbroke, the Earl of Lauderdale, the Earl of Halsbury, Mr. E. van Dien (President of the Second International Congress of Accountants), Colonel Robert H. Montgomery (President of the Third International Congress of Accountants), Viscount Rothermere, Viscount Goschen, the Netherlands Minister, the Norwegian Minister, Field-Marshal Lord Allenby, Sir James Martin (Vice-President of the Congress), Lord Faringdon, the Mexican Minister, Lord Askwith, Sir Thomas Kelly, Lord Ebbisham, the Swiss Minister, Lord Jessel, Mr. C. J. Shiells (President, Society of Accountants in Edinburgh), Lord Arnold, Herr Dr. Wilhelm Voss, Lord Essendon, Lord Luke, Mr. Thomas Geoghegan, Mr. Justice Eve, Lord Macmillan, Lord Wright, Lord Blanesburgh, Mr. A. S. Fedde, Mr. H. L. H. Hill (President of the Institute of Chartered Accountants in England and Wales), Lord Tomlin, Mr. John F. Forbes, the Minister for Finland, Professor D. Himmelblau, Lord Horder, Mr. E. Cassleton Elliott (President of the Society of Incorporated Accountants and Auditors), Sir Hugh O'Neill, Mr. Henry Morgan, Herr Professor O. Sillén, Mr. H. F. Kemp, Mr. Sheriff W. L. Threlford, Lieut.-Colonel H. D. Lockart Gordon, Sir Nicholas Waterhouse, Herr Christian Sommerschild, the Rt. Hon. Lord Justice Lawrence, Mr. Maurice E. Peloubet, Mr. T. Herbert Hughes, Councillor J. McLaren Biggar, Monsieur C. Jespersen, Herr Kurt Elfborg, Sir James Grigg, Mr. Will Appleton, Brig.-Gen. Sir Arthur Maxwell, Sir Percy Simmons, Sir Patrick Hastings, Sir Richard Hopkins, Sir Walter Greaves-Lord, Mr. Ernest H. Griswold, His Honour Judge Cecil Whiteley, Viscount Leverhulme, Lord Rochester, Monsieur Honoré Sénéchal, Mr. Justice Bennett, Mr. Andrew Stewart, Mr. C. Hewetson Nelson, Sir Gilbert Upcott, The Dean of St. Paul's, Mr. Stefan Wojciechowski, Mr. John E. Dalgliesh, Mr. H. Gordon Selfridge, Mr. E. C. Grenfell, Judge Sir Alfred Tobin, Sir Ralph Harwood, Sir Bernard Halsey-Bircham, Sir Hugh Allen, Monsieur Roger Jollet, Hon. George Colville, Sir Lynden Macassey, Mr. Thomas Keens, Sir Arthur Robinson, the Hon. David L. Grey, Sir Oswald Simpkin, Herr P. I. Boreh, Sir Edward Knapp-Fisher, Sir Gerald Wollaston, Monsieur H. J. Volkers, Mr. Stuart Bevan, M.P., Sir Emsley Carr, the Hon. Walter Boyle, Sir Claud Schuster, Sir Sydney Chapman, Monsieur le Doyen N. Butculescu, Sir Charles J. Howell Thomas, Mr. Alexander S. Banks, Sir Angus Scott, Mr. D. M. Muir, The Dean of Westminster, Sir Reginald Poole, Sir William Hansell, Mr. R. W. Bankes, Sir G. Stuart Robertson, Sir Holburt Waring, Monsieur le Professeur Trancu-Iasy, Sir Charles Grant Robertson, Mr. John Hyde, Herr Adolf Fahrni-Lenz, Sir Edward Crowe, Sir Josiah Stamp, Admiral of the Fleet Sir Henry Oliver, Mr. L. Hore-Belisha, M.P., Mr. A. A. Garrett, Dr. Kotaro Fujimoto, Monsieur le Dr. P. Draganescu Brates, Monsieur J. P. Strobel, Sir Robert Kinderaley, Señor Alfredo Chavero, Sir Murdoch Macdonald, M.P., Monsieur Kamil Augsten, Sir Vansittart Bowater, M.P., Mr. A. E. Cutforth, Sir William Ray, M.P., Mr. F. Woolley, Sir Herbert Austin, Sir Edward J. Harding, Sir William Goschen, Mr. J. W. Dulanty, Sir A. Lowes Dickinson, Sir Felix Cassel, Admiral the Hon. Sir Stanley Colville, Professor W. Annan, Dr. Leslie Burgin, M.P. Sir Montagu Cox, Sir Maurice Jenks, Mr. Walter A. Staub, Mr. J. C. Latham, Mr. R. Wilson Bartlett, Monsieur Marc Barbut, Sir Francis Floud, Sir Albert Wyon, Herr Kammerrat Fritz Spohn, Mr. J. Stirling Brown, Alderman Charles Latham, Mr. Fred Whittingham, Mr. Adam Maitland, M.P., Mr. John Potter, M.P., Mr. E. E. Mills, Mr. E. E. Edwards, Mr. Frank Mellor, Mr. Walter P. Norton, Sir James Rae, Sir Herbert T. Robson, Mr. R. A. Wetherall, Mr. W. S. Wilkinson, Mr. D. Williams, Mr. M. G. Willmott, Mr. J. J. Wills, Mr. F. Wilson, and Mr. J. H. E. Wilson.

"The Fourth International Congress on Accounting."

The Loyal Toasts having been duly honoured—

H.R.H. PRINCE GEORGE, K.G. (who was received with applause) said: I am very pleased to be here this evening to propose the toast of "The Fourth International Congress on Accounting." International business is not made easier by the difficulties arising from different languages and currencies, but, so far as accountancy is concerned, these difficulties are to a great extent dissipated by the fact that the accounts of nearly all the nations are prepared according to well-tried and universally used principles. That this is so is indicated by the fact that there are here delegates from nineteen different countries. Anyone wishing to trade with another country would probably find that no difference in principle exists in the way in which accounts are kept. Although this is the first occasion on which your International Congress has been held in this country, I hope it will not be the last. (Hear, hear.) It does surprise me that this should be only the fourth International Congress of the members of your profession. It seems curious that accountancy should not have been recognised as a definite profession from a much earlier date, similar to the establishment of doctors, lawyers, &c. From the earliest days of trading, even at the time of the Phœnicians, merchants saw the necessity of keeping accounts, and, what is more important, of having an expert on figures close at hand to explain to them the details of their profit or loss on any venture. At the present time the necessity for good accountancy and of taking the advice of accountants is becoming more and more widely recognised—(hear, hear)—so much so that many companies have an accountant as a member of the Board. It seems to me that an accountant who is employed, not as an auditor alone, should be regarded as much as a necessity to the directing of the company's activities as a general practitioner is to a large and growing family. The general practitioner watches the family as it grows and warns the parents when the distress signals appear. (Laughter.) Similarly, the duty of the accountant on the Board would be to indicate the treatment necessary if the figures begin to take on an unhealthy appearance in any particular part of the business. In addition to the helpful services of accountants to companies and businesses generally, it seems obvious to me that the assistance of the accountant to a private individual is becoming more and more a necessity. Personally, I have my own accounts audited every year in order that I may know where I stand. (Laughter and applause.) The activities of the accountant cover such a wide sphere that his advice and assistance are indispensable to the commercial man. The high standard demanded to-day can only be achieved as a result of training in order to pass the most searching examinations. Those who

contemplate entering your profession may hesitate and ask, "Why should I pass such stiff examinations and then have to wait so long before I can earn a good living?" To those I would say that it must be remembered that the plums of your profession are of a high standard and very remunerative, and should amply repay their hard labours. (Hear, hear.) A knowledge of accounts is a necessity in every walk of life. So strongly do I feel this that I hope the practice recently instituted of giving a boy a grounding in business methods during the last year of his school life will be considerably extended, and that accountancy will fill an important part in this business training. Furthermore, I suggest it is necessary that the teachers make themselves fit for this important part of their work by attending lectures dealing with the practical side of this subject, thus amplifying and perfecting the theoretical knowledge to be gained from text-books. The points I have dealt with are not peculiar to this country; they apply with equal force to all countries, and because of this I consider myself privileged to address such a unique gathering of those practising the age-old and honoured profession of accountancy. In conclusion, I wish every success to the Fourth International Congress on Accounting, and I hope that by discussing your various problems in a spirit of mutual co-operation lasting benefit will result, not only to yourselves personally, but to all the countries which you represent. Now, gentlemen, I will ask you to rise with me and drink to the health of the Fourth International Congress on Accounting, coupled with the names of your Chairman (Lord Plender) and Colonel Montgomery. (Loud applause.)

The CHAIRMAN (Lord Plender, G.B.E., F.C.A.), in responding to the toast, said: The recognition of the value of a professional accountant's work and influence is universally accepted, and your Royal Highness's confirmation of this fact gives pleasure and satisfaction to this large and representative gathering of delegates and visitors from many nations. There are few countries in the world where our services are not available and made use of, and as each year passes such services become more and more part of a country's industrial, commercial and financial life. Legislation here affecting limited liability companies compels the employment of auditors, but this statutory obligation is not yet common to countries outside the British Empire, and the hope of many delegates present is that compulsory annual audits of public companies, and of corporations as they are sometimes called, will be regarded as a desirable necessity by their own Governments. The International Congress now sitting aims at securing a free exchange of experience and opinions on many of the problems in accountancy which have not only a relation to practice in this country, but have international characteristics. They cannot, however, be wholly standardised, as laws of nations and judicial dicta affecting accounts and auditors differ, and the scope of their duties in the countries of the world with different conceptions of duty and responsibility do not correspond. But there are points of resemblance, and, as far as is practically possible, uniformity in main principles should be aimed at. The ruling idea ought to be to state facts as closely as they are ascertainable, and this end is what we all seek to accomplish; but sometimes the road to attainment is strewed with impediments and the finish is not easy to reach. It may interest your Royal Highness to know that the eight sponsoring bodies responsible for convening the Congress have a membership of 25,000, and that there are other important bodies in this country the membership of which numbers some thousands, such as the Institute of Municipal Treasurers and Accountants, the Institute of Cost and Works Accountants, and the Institute of Bookkeepers, whose functions bear a relationship to public accountancy. We do not know the membership of all the organised Accountant Societies throughout the British Empire overseas, the United States of America, the Continent of Europe, and the Far East, but there must also be many thousands of them. There is, as your Royal Highness has observed, hardly any section of the community that does not requisition our services; and every Government in Great Britain, whatever its political complexion may be, seeks our aid in appointing members of our Institutes and Societies to serve on Royal Commissions, Departmental Committees, and also in other less public ways. This is a testimony to our usefulness and a recognition of our help which we greatly appreciate. This is not the time nor the place to enter into all the classes of work which fall to us to undertake, but they are surprisingly varied, from the birth to the burial of companies, and from their resurrection to a new and enlarged life. But the illustrations which your Royal Highness has given are typical of the comprehensive nature of the duties we fulfil. No profession offers more possibilities of useful public service—often onerous and carrying heavy responsibilities, but always of absorbing interest and not seldom illuminating in their disclosures. Rapid as has been our growth in recent years, the profession continues to enlarge year by year, notwithstanding the severity of examinations before membership can be secured, and we have far from reached the limits of its possibilities, which increase as business becomes more intricate and specialised, as case law relating to Income Tax extends, as problems arise affecting accounts of subsidiary companies, as capital structures of companies in distress need revision, and as exchange disturbances and restrictions affect the results of trading. We know how critically our work is regarded and how much our reputation is dependent on its reliability, and how character counts as in all other walks of life; but, stimulated by your Royal Highness's words and fortified by the confidence of clients and the public, we shall strive not to be undeserving of that confidence. We meet to-night in the Guildhall by the courtesy of the Lord Mayor and Corporation of the City of London—(applause)—and to the delegates and visitors from overseas, this ancient hall, with its wonderful memories and its stately monuments, must give—as

it always gives to the citizens of London—a feeling of continuity, of pride, and of inspiration. The nations of the world, of whom there are many representatives present, need to-day more than ever to approach to closer friendly relations, a kinship of motives, and a common purpose that is not bounded by geographical limits. The contacts of men from all countries should help to harmonise conflicting views, leading to a closer and a better understanding, and, in so far as our own profession is concerned, the Congress now sitting will not be found wanting. When our visitors return to their own countries after a week of effort which the uninitiated public might regard as almost sepulchral in its dismalness —though relieved at times by spasms of restrained gaiety—we hope they will regard us with tolerance which our natural modesty forbids us to magnify into hero-worship, and that, after all, we as a people with all our faults have a little genius for friendship. Experience has disciplined us. The past with its successes and its mistakes lies behind, but whatever our failures may have been, we can with modesty say that we have tried to be loyal to the aims and objects which were the guiding principles of those who founded the several Institutes and Societies throughout the world, to which we belong. The story of the future is untold, but when it is unfolded in years to come, we of to-day hope that it will be a story of services still more extended, of high purposes fulfilled, and of ideals realised. We thank your Royal Highness for the great honour you have paid us and for your words of encouragement and good wishes for the success of the Fourth International Congress on Accounting, and we assure your Royal Highness that your visit to-night will long be gratefully remembered by all of us. (Applause.)

Colonel R. H. MONTGOMERY (who was received with applause), in responding to the toast, said: Before leaving America I heard it whispered around that the word "debts" was to be tabooed while in Europe. Your Royal Highness may not know it, but accountants are quite used to ignoring instructions, and I am tempted to ignore this admonition, and transgress, if you will. But the debts I want to mention are debts of gratitude—(laughter)—gratitude to our hosts, our British accounting brethren, for the deep-rooted and sound fundamentals of accounting theory, practice and ethics we have inherited from them; to your Royal Highness for your kind and generous welcome; and to you, Lord Plender, for this festive gathering here to-night. I am deeply sensible of the honour which has been accorded in permitting us to gather in this historic hall, rich with its atmosphere of traditions, and in being greeted by some of Britain's foremost sons. It is a proud day for accountants. When we again cross the seas and return to our homes we shall carry with us a memory which time will not erase, and one which will symbolise the international good fellowship and friendly co-operative spirit so manifest here to-night. Four years ago it was my privilege to welcome the delegates to the Third International Congress on Accounting held in New York. At that time we were riding on the crest of the wave of success, which has now receded into the far distance, leaving us upon a different level. This four years period has been one of stress and strain for most of us, while the world has been seeking a means of recovery from its economic ills. We have had new lessons to learn, and in the process it has also been necessary to unlearn not a few of the old ones. The tracks through the wilderness of financial and industrial uncertainties which the accountant has been required to chart have increased tremendously in number and in character of terrain. His responsibilities now embrace fields not hitherto envisioned. To successfully face these new conditions we now and again need time for meditation in order that we may retrace our steps back to the fundamental theories of accountancy and make sure that our newly-trodden ways have not become so devious as to obscure the pivotal starting point. We could have no better opportunity for such meditation than is now presented by this Fourth International Congress. We are assembled here in the country in which the practice of accountancy was first developed and where it first attained widespread and respected standing. In such an atmosphere and amid such traditions our deliberations will be carried on under the most favourable and happy auspices. It is an honour, a privilege, and a pleasure to attend this Fourth International Congress on Accounting. I had some part in the first Congress in St. Louis in 1904; in Amsterdam in 1926, and in New York in 1929. Not one of them would have been a success had it not been for the British attendance and participation. When we very properly speak of the 1904 Congress, held in St. Louis, as the First International Congress on Accounting, we must not forget that it was a British accountant —George Wilkinson—who first thought of it, who organised it, and who made it a success. Perhaps he was influenced by the land of his adoption, but those of us who knew and loved him well, recall that he never lost his pride in British traditions, which he so well exemplified. In the years immediately following, Sir Arthur Dickinson was a tower of strength in directing the ethics and practice. He is here this evening. (Applause.) I am not sure that in St. Louis and in New York the British delegates always wanted to attend the almost continuous and highly technical sessions usually held in terrifically hot weather (and they always wore too many clothes), but they were such thoroughly good sports that they never dreamt of letting their hosts down. Their energy and interest were unbounded. They discussed every subject. They were always sure that they were right, and sometimes they were! I am afraid that the delegates and visitors at this Congress will not do half so well, but we do not have their reputation to sustain. I have come to the conclusion that a nation is great in direct proportion to the number of professional accountants within its borders. Go to any place you like in the world, and there you will find the British accountant. Visit England, and you will find him represented in all that has made Britain great. And this goes on even though you have a most terrible climate and

you wear too many clothes in hot weather. There may be an over-production of pretty much everything throughout the world, but there has been no over-production of professional accountants in England or in the United States. It is not surprising that the World Economic Conference is about to adjourn. Their problems, national and international, as they saw them, were insoluble, but they would have been more nearly solved if accountants had been permitted to resolve all questions into debit and credit. England would be proud of the result. You have more and bigger credits than you have debits. Your debits are so few and so small that we hardly bother to mention them. Although I should refer to the corrections you made in the spelling of some of the words in our papers, I am sure that you are wrong, but all I did was to moan softly to myself and let it go at that. The balance of these debits and credits in your favour would be so large that it would astonish you, even though you have an extremely good opinion of yourselves! Internationalists are not popular to-day. Trade and race barriers and prejudices are being built up faster than they are being torn down. Accountants have had no part in their building up; they would like to have a part in the tearing down. They could settle the question of currencies, tariffs, war debts, and reparations by again applying their inexorable principles of debit and credit. It is hardly necessary to prophesy how England would come out in the balance. You would not need to have a single British accountant to make, nor to audit, the entries. You could choose the accountants by lot from any country in the world, and the result would be the same. The honour and the integrity of the British nation, as carried round the globe by the British accountant, have left an indelible impression of fairness, honesty and righteousness, and as you have dealt with others so others will deal with you. All over the world the British accountant has been found—and for what purpose? It has been to seek the truth, and when it is known that what you want is the truth, the whole truth and nothing but the truth, the seeker of the truth justly acquires a reputation for fair play and honesty in his dealings with his fellow men. This truth I have referred to has dealt chiefly with production, distribution and consumption of tangible rather than intangible things, but when the British went on decade after decade striving to ascertain nothing but the truth in respect of tangible things it becomes easy to understand why it is that in what we call the finer things of life—religion, the arts, sciences, politics—the British have sought and still seek the truth. They do not believe that any living man has a monopoly of brains or genius, but that the human race is still so fallible that we must keep on seeking the truth about every subject until we find it, and that in the meantime we must have open minds. I have said that all over the world you find the British accountant. You can always tell a British accountant, but you can't tell him much! May the British accountants continue to carry the proud banner of Britain throughout the globe and continue to give us, who live in better climates and who wear fewer clothes in the summer-time, an example of high thinking at all times, courage when it is most needed, and friendship which is as genuine and as tight and as right as your little island has been and always will be. We thank you for your cordial greetings and for your boundless hospitality. Our respect and affection for British accountants, which needed no acceleration, nevertheless has been broadened and strengthened. We hope to come again. (Applause.)

"The Guests."

Sir JAMES MARTIN (Vice-President of the Congress) said: I think I am somewhat entitled to your sympathy, because whatever I may have to say is limited to the Fourth International Congress on Accounting, and you have already heard on this subject His Royal Highness; my Lord in the Chair, and Colonel Montgomery. But I am cheered by this fact, that, on behalf of the sponsors of this Congress in England and Wales, in Scotland, and in Ireland, I have both the honour and the pleasure of submitting for your cordial acceptance the toast of "The Guests." (Applause.)

Twenty-nine years have passed since, on a very hot September night, at St. Louis, U.S.A., I responded with a valued English colleague to a similar toast, which I recollect was drunk with enthusiasm, somewhere about two o'clock in the morning. (Laughter.) Of those who were at that, the first international gathering of accountants, eight are here to-night, two as hosts and six as guests. With the name of one of the latter I propose in a few moments to associate the toast. At the banquet of 1904 there were 119 hosts and guests, including ladies. Here to-night we number about 700, but, alas! the ladies are absent, as even this Guildhall could not accommodate all who desired to be present. As one of the senior citizens of this great City, it is a great joy to me that the Lord Mayor and Corporation have so kindly and graciously allowed us to gather here on this interesting occasion. Although this historic building cannot claim a longer record than five hundred years, it is a fact that the site of the ancient Guildhall on the land adjoining has been consecrated to civic government for more than a thousand years. It is here that English liberty has been gradually evolved by the citizens, and it is here that we shall ever protect the inheritance of which we are so proud. (Applause.) Our guests to-night must be divided into two sections: those who from twenty-three countries including the overseas Dominions of the British Empire, have accepted our invitation to come to Great Britain and Ireland, and those distinguished in every walk of life, headed by His Royal Highness, who have honoured the accountants of the world by coming here to meet and welcome them. Among those distinguished men is His Grace the Lord Archbishop of York. (Applause.) That beautiful service which was held in Westminster Abbey at the opening of the Congress, by the kind permission of the Dean, reminded us that we accountants are the custodians of the great principle of mutual trust. All of us will be glad of the opportunity of

hearing His Grace respond to this toast. For our guests from other lands I am going to ask my friend of twenty-nine years standing, Mr. E. van Dien, of Holland, to reply. Mr. van Dien was, as I have already indicated, a delegate to the First International Congress, and the President of the Second Congress, held in Amsterdam. To all those who have come to our shores I desire to express our earnest wish in ancient language: "Peace be within thy walls, and plenteousness within thy palaces. For my brethren and companions' sakes, I will wish thee prosperity." (Applause.)

The ARCHBISHOP OF YORK (who was received with applause), replying to the toast, said: Those who have had the arrangement of the programme of this Congress have indeed conferred upon me a very signal honour. Not only was I allowed to speak at that most impressive service in Westminster Abbey, to which allusion has just been made, but you have singled me out—and you will shortly discover how appropriately—to reply to the toast on behalf of the guests on this occasion—at least, for those of them who reside in these islands; appropriately, because I am indeed one of those whose financial state needs careful watching. (Laughter.) I do not know what may be the condition of His Royal Highness's accounts when the accountant to whom he refers presents his report; but I know that my own way of doing my accounts is to add them up and then to add them down, and then to take the difference between the two results. (Laughter.) That I find to come near enough for all practical purposes—(laughter)—until I receive further information from a banker or someone else learned in the low arts of arithmetic. On that other occasion I ventured to refer to accountants as the custodians of the mutual trust and of the integrity of industry and commerce, a most sacred function and a function rendered all the more important and in some respects all the more difficult by a paradox which is inherent in the nature of industry and commerce—I mean that the method, at any rate as we are familiar with it, is in a high degree competitive, and it must appear very often to those who are engaged in these occupations that they are engaged in a perpetual attempt to get the better of someone else, if they can—(laughter)—whereas they know quite well in their hearts that industry and commerce only flourish when the benefit of all parties concerned is really served. (Hear, hear.) Commerce does not prosper when one of the partners to a transaction secures a benefit at the cost of the other. It flourishes only when there is a benefit to both partners as the result of their mutual transactions. (Hear, hear.) And the same thing is true of industry, with the financial aspects of which you are so intimately concerned. Our reformers sometimes tell us that there ought to be public services, co-operative schemes, conducted for the public benefit, but it never is anything else. People may practise, as it were, something else, but it can never be anything else; it only exists to serve the public; for it is only if the public wants its produce that it can go on at all, and it can only go on so long as the various factors within it are co-operating with one another. The fact is, of course, that these two apparently alien principles of competition and co-operation can be wrapped up in one another to any extent you like. Our visitors from overseas are aware that in this country we are much addicted to games that are played between teams. I will not say anything of the main summer occupation of our islanders, because my views on that subject would be unpopular. (Laughter.) I have a feeling that if only it had been developed on the principles of tip and run, cricket once had the makings of a game. (Laughter.) But as that great opportunity was neglected it has developed into an occupation. (Renewed laughter.) There is a game we play in winter called football, and if it were the kind of game that it ought to be, there would be thirty players—(laughter)—all of whom are co-operating for the fun of the game; and the way that they co-operate for the fun of the game is for fifteen of them to compete against the other fifteen, while at the same time each individual is competing with his fellow members of the team to be the best co-operator in the process of competition for the sake of the game. (Laughter.) I want to submit to you that if you can wrap up these principles with one another like that in a mere game, you need not suppose that anything as complicated as industry or commerce has got to be either purely competitive or purely co-operative; it is likely to be done on a large scale; but in the case of the game it makes all the difference in the world which is uppermost, because if the co-operative spirit is uppermost you are a good sportsman, who would rather be defeated in a good game than win a walkover, whereas if the competitive spirit gets uppermost you get the kind of team who play only to win, and who will do any dirty trick that the referee will let them. (Laughter.) One of your great functions is to set a limit beyond which those who have not got the co-operative spirit in industry and commerce shall not be allowed to step so that the whole credit of the structure of these great human activities may not be imperilled. But even where players are good sportsmen the referee is still wanted, for it is impossible for those who are engaged in the process of the game always to see perfectly well when the rules are being kept, even though there is the utmost intention to keep them, and a player may very well be off-side without knowing it. (Laughter.) Well, it is in some such way as that that those of us who are outside your mysteries and do our own accounts, in the way which I have already described as my own habit, regard your functions in the civilised world, and, consequently, our gratitude, which is most sincere for your hospitality this evening, is mingled with the gratitude for a profound service to the welfare of mankind. (Applause.)

Mr. E. VAN DIEN, F.S.A.A. (who was received with applause) said: I am much honoured by the invitation to answer to the toast of "The Guests," and I thank Sir James Martin for the friendly manner in which he has introduced my name in this connection. It is very difficult, especially for a foreigner,

to find new adjectives to express the admiration we all have for the manner in which British colleagues entertain their guests. I therefore may be allowed to tell you something like a fairy tale that happened to me during this Congress. I have the great favour to have my wife with me during these days, and, as a matter of course, one of the subjects we discuss is: What dress she should wear at the different festivities she is invited to attend. We always agree in these matters, as she always wears the dress *she* thinks fit. Now, on one occasion it was agreed that she was going to wear a black dress, that she would put on some flowers, and it was agreed that it would be pink carnations, and at the moment that I went to the telephone to order the carnations there was a knock at the door, and a boy brought a box for Mrs. van Dien, containing pink carnations with the compliments of the Executive Committee. Now, the only thing that we said to each other was: "This is like a fairy tale! It is quite British! They don't say much, but they do, and they do excellently." May I once more thank you in the name of the guests and on my own behalf for the splendid entertainment of this evening, and for the opportunity you have given me to express these thanks. I finish with the words of my friend Montgomery: We hope to come again. (Applause.)

"The Chairman."

The MARQUIS OF READING said: You have had a series of excellent speeches, and the only excuse I offer for making a speech at this moment is that it is to propose a toast which I am certain will be received by you with acclamation, and that is the toast of your Chairman, Lord Plender. (Applause.) Good wine needs no bush, we learn. I saw it quite recently corrected by the Prime Minister, who told us that good wine needs good bush; but then he was speaking at an Advertising Convention. (Laughter.) In this society, amongst all of you, it is really hardly necessary for me to say a word about Lord Plender. I have had a long friendship with him. A long association over many years in different capacities impels me just to keep you for some three or four minutes, and no more at this time of night. I thought I knew much of what Lord Plender had done during his very busy life, but I looked in "Who's Who," as some of you may have done when you have had the honour of proposing a toast, and I found such a record that I was absolutely staggered. I knew much of what Lord Plender had done, but I certainly had no conception of the many posts that he had filled, both international and national. This I did know, that he stands very high in the estimation of his country. (Applause.) His position in the world of accountancy is illustrated by his presence here this evening—by his Presidency over this great Congress. I was glad indeed to learn from him during his speech that this Congress, with all its difficulties, is going to prove successful. That is not always the fate of International Conventions. (Laughter.) We are glad that at this moment this Conference is successful, as it was almost certain to be with Lord Plender at its head. I have listened to-night to much which has been said about the profession of accountancy, and especially from your Royal Highness, when you said that, in these days particularly, it is so eminently desirable that our young men should have the opportunity of studying and of obtaining at least some knowledge of accountancy. As to whether to debit an item to capital or revenue, whether it should be debited to obsolescence, or whether it should be brought in as special expenditure on maintenance; as to whether an item could properly be carried to Suspense Account and written off during a number of years, instead of being taken straight away from the revenue of that year—(laughter)—all those are questions into which we will not enter to-night. But, my Lord Plender, may I say, after a very long experience of your profession and of you, an experience in various capacities which I have had to fill, I feel that it is on the integrity of purpose of accountants, the character of the men, that we depend for the confidence that we place in our accountants and the trust that is generally reposed in them? I know very well the kind of pressure and arguments that may sometimes be used, particularly in difficult years, when the balance sheet comes to be drawn up; but the accountant who is worthy of his profession stands firm, resists the arguments and withstands the pressure if he is convinced that he is right, and, notwithstanding all that may happen, insists upon stating the truth in his certificate. That is the reason why accountancy stands so high with us. And now, my Lord President, I must content myself with making these few observations, conscious as I am of the pleasure that we all feel in drinking to the health of him who was distinguished only, I think, some two years ago by His Majesty the King, by being raised to the Peerage as a mark of appreciation of his public services during his life and of the character which he had displayed throughout. I give you the toast of "The Chairman." (Applause.)

LORD PLENDER, in reply, said: The noble Marquis, in proposing my health, has shown that kindness of heart in his references to me which is so characteristic of his generous nature. I shall long remember his words to-night, and I thank him, as an old friend, for all he has said, and I also thank this great audience, drawn from many countries, for the warm reception given to the toast. Whilst at the Bar and throughout his long and devoted life to the interests of his country, his Lordship has always been ready to recognise the little efforts which others make in public service and for their profession, and to overlook their shortcomings, which in my case are many. Lord Reading belongs to that great profession of the law—the guardians of liberty—whose members are among our best friends. There is a Common Law upon which has been built the structure which holds for the English-speaking races a conception of justice that nothing can shatter, and there is a law of nations which Justinian says is that which natural reason appoints for all mankind because all mankind uses it. There should be no boundary between nations in a common devotion to right, and in our profession, as in the law, there are principles which everyone engaged

in its pursuit the world over should observe in trying to arrive at truth. We all have some ideal to guide us, some goal we wish to reach, and if we strive and seek we shall find. (Applause.)

On Friday, July 21st, a Paper was read on

THE AUDITOR'S RESPONSIBILITY IN RELATION TO BALANCE SHEETS AND PROFIT AND LOSS ACCOUNTS.

THE BRITISH POINT OF VIEW

BY

Mr. HENRY MORGAN, F.S.A.

Mr. H. L. H. HILL, F.C.A., occupied the chair.

Mr. MORGAN said :—

The accountancy profession in Great Britain has developed rapidly this century in the scope of its activities and the extent of its responsibilities. There is, however, no aspect of the professional accountant's work which carries heavier responsibility and presents greater difficulties than his duties as auditor of joint stock companies. There has been an enormous expansion in joint stock company practice during the last thirty years, as is demonstrated by the great increase in the number of companies and shareholders. There exists to-day a far larger number of great industrial and commercial combinations, with tens of thousands of shareholders, and this, coupled with the rapid extension of the holding and subsidiary company principle, has further increased the difficulties of auditors of public companies.

COMPANIES ACT, 1862: OPTIONAL ACCOUNT AND AUDIT PROVISIONS.

Under the Companies Act of 1862, which applied to Great Britain and Ireland, it was not obligatory for a company to appoint an auditor, and the Act contained no clauses as to balance sheets, accounts or audit, except the optional provisions concerning accounts and audit in Table "A," being the First Schedule to the Act. Although any company could thus reject any or all of such provisions, it was customary for companies of any size or importance to provide by their regulations for the appointment of auditors, the audit of their accounts and the certification of their balance sheets. The auditor's duties at that time were set out in Clauses 83, 92 and 94 of Table "A," which read as follows, and may be regarded as having been based upon correct practice :—

(83) Once at the least in every year the accounts of the company shall be examined, and the correctness of the balance sheet ascertained, by one or more auditor or auditors.

(92) Every auditor shall be supplied with a copy of the balance sheet, and it shall be his duty to examine the same, with the accounts and vouchers relating thereto.

(94) The auditors shall make a report to the members upon the balance sheet and accounts, and in every such report they shall state whether, in their opinion, the balance sheet is a full and fair balance sheet containing the particulars required by these regulations, and properly drawn up so as to exhibit a true and correct view of the state of the company's affairs and in case they have called for explanations or information from the directors, whether such explanations or information have been given by the directors, and whether they have been satisfactory ; and such report shall be read, together with the report of the directors, at the ordinary meeting.

COMPANIES ACT, 1879: PROVISIONS FOR AUDIT OF ACCOUNTS OF BANKING COMPANIES.

The Companies Act of 1879 contained provisions relating to the audit of the accounts of banking companies. With this restricted exception, no Companies Act until the year 1900 contained obligatory provisions as to balance sheets, accounts or audit. Between the years 1879-1900 however, a number of important cases came before the Courts relating to the duties, obligations and responsibilities of auditors. The judgments given went far to settle the principles by which auditors should be guided and their actions judged and had no little influence on subsequent legislation.

MR. JUSTICE LINDLEY ON THE DUTIES OF AN AUDITOR, 1895.

The most important case was that of *The London and General Bank, Limited*,* in the Court of Appeal in 1895. In a memorable judgment, quoted ever since, Mr. Justice Lindley laid down the principles which should govern an auditor in the discharge of his duties and it is generally agreed that these principles hold good at the present time. It was held that an auditor is guilty of misfeasance who, when dissatisfied with the accounts of a company, does not plainly draw attention in his report to the grounds for his dissatisfaction. From the judgment, which was a long one, I have extracted the following parts dealing generally with the duties, obligations and responsibility of the auditor :—

"It is no part of an auditor's duty to give advice, either to directors or shareholders, as to what they ought to do. An auditor has nothing to do with the prudence or imprudence of making loans with or without security. It is nothing to him whether the business of a company is being conducted prudently or imprudently, profitably or unprofitably ; it is nothing to him whether dividends are properly or improperly declared, provided he discharges his own duty to the shareholders. His business is to ascertain and state the true financial position of the company at the time of the audit, and his duty is confined to that. But then comes the question : How is he to ascertain that position ? The answer is : By examining the books of the company. But he does not discharge his duty by doing this without inquiry and without taking any trouble to see that the books of the company themselves show the company's true position. He must take reasonable care to ascertain that they do. Unless he does this, his duty will be worse than an idle farce. Assuming the books to be so kept as to show the true position of a company, the auditor

* *In re London and General Bank* (No. 2) (1895, 2 Ch., 673).

has to frame a balance sheet showing that position according to the books, and to certify that the balance sheet presented is correct in that sense. But his first duty is to examine the books, not merely for the purpose of ascertaining what they do show, but also for the purpose of satisfying himself that they show the true financial position of the company. This is quite in accordance with the decision of J. Stirling in *The Leeds Estate Company* v. *Shephard*, in 36 Chancery Division, page 802. An auditor, however, is not bound to do more than exercise reasonable care and skill in making inquiries and investigations. He is not an insurer; he does not guarantee that the books do correctly show the true position of the company's affairs; he does not even guarantee that his balance sheet is accurate according to the books of the company. If he did he would be responsible for error on his part, even if he were himself deceived without any want of reasonable care on his part—say, by the fraudulent concealment of a book from him. His obligation is not so onerous as this.

"Such I take to be the duty of the auditor; he must be honest—that is, he must not certify what he does not believe to be true, and he must take reasonable care and skill before he believes that what he certifies is true.

"What is reasonable care in any particular case must depend upon the circumstances of that case. Where there is nothing to excite suspicion, very little inquiry will be reasonably sufficient; and in practice I believe business men select a few cases haphazard, see that they are right, and assume that others like them are correct also. Where suspicion is aroused more care is obviously necessary, but still an auditor is not bound to exercise more than reasonable care and skill even in a case of suspicion; and he is perfectly justified in acting on the opinion of an expert where special knowledge is required.

. . . . . .

"The balance sheet and certificate of February, 1892 (that is, for the year 1891) was accompanied by a report to the directors of the bank. Taking the balance sheet, the certificate and report together, Mr. Theobald stated to the directors the true financial position of the bank, and if this report had been laid before the shareholders, Mr. Theobald would have completely discharged his duty to them. Unfortunately, however, this report was not laid before the shareholders, and it becomes necessary to consider the legal consequences to Mr. Theobald of this circumstance.

"A person whose duty it is to convey information to others does not discharge that duty by simply giving them so much information as is calculated to induce them or some of them, to ask for more. Information and means of information are by no means equivalent terms. Still, there may be circumstances under which information given in the shape of a printed document circulated amongst a large body of shareholders would, by its consequent publicity, be very injurious to their interests, and in such a case I am not prepared to say that an auditor would fail to discharge his duty if, instead of publishing his report in such a way as to ensure publicity, he made a confidential report to the shareholders, and invited their attention to it, and told them where they could see it. The auditor is to make a report to the shareholders, but the mode of doing so, and the form of the report, are not prescribed. If, therefore, Mr. Theobald had laid before the shareholders the balance sheet and profit and loss account, accompanied by a certificate in the form in which he first prepared it, he would perhaps have done enough, under the peculiar circumstances of the case. I feel, however, the great danger of acting on such a principle, and in order not to be misunderstood, I will add that an auditor who gives shareholders means of information instead of information in respect of a company's financial position does so at his peril, and runs the very serious risk of being held, judicially, to have failed to discharge his duty.... But, as already stated, the duty of an auditor is to convey information, not to arouse inquiry, and, although an auditor might infer from an unusual statement that something was seriously wrong, it by no means follows that ordinary people would have their suspicions aroused by a similar statement, if, as in this case, its language expresses no more than any ordinary person would infer without it."

COMPANIES ACT, 1900: APPOINTMENT OF AN AUDITOR OBLIGATORY; HIS CERTIFICATE, REPORT AND DUTIES.

The Companies Act of 1900 effected important alterations in company law. For the first time it was made obligatory for every company to appoint an auditor. Sect. 23 of the Act relating to the auditor's duties read as follows:—

"Every auditor of a company shall have a right of access at all times to the books and accounts and vouchers of the company, and shall be entitled to require from the directors and officers of the company such information and explanation as may be necessary for the performance of the duties of the auditors, and the auditors shall sign a certificate at the foot of the balance sheet stating whether or not all their requirements as auditors have been complied with, and shall make a report to the shareholders on the accounts examined by them, and on every balance sheet laid before the company in general meeting during their tenure of office, and in every such report shall state whether, in their opinion, the balance sheet referred to in the report is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs as shown by the books of the company; and such report shall be read before the company in general meeting."*

Prior to 1900, auditors' certificates had almost invariably become stereotyped in form and restricted to the balance sheet. The Act of 1900 provided for a

* This wording follows almost exactly that of sect. 7, Clause 6, of the Companies Act of 1879 relating to Banking Companies only, and applied in the case of *In re London and General Bank* (No. 2), referred to above.

certificate and a report. The report had to deal, in the first place, with the accounts examined by the auditor and had to be read before the company in general meeting. There was much controversy as to the exact meaning of sect. 23 and contemporary accountancy publications show that there existed considerable confusion and uncertainty as to the procedure necessary to comply with it. In December, 1900, *The Accountant* published a series of articles upon "The Duties of Auditors under the Companies Act, 1900," from which I give two interesting extracts :—

"If an absolutely unqualified certificate is really all that an auditor has to report to the shareholders, then it is obvious that he will have nothing to add to the certificate as to the accuracy of the balance sheet, which the Act requires him to affix to the foot thereof, and no harm can possibly be done by omitting to give one. At the same time, now that the Legislature expressly requires that a report shall be addressed to the shareholders, considerable responsibility will necessarily rest with the auditor who omits to make such a report, especially if there is anything like a conflict of opinion as to whether or not anything ought to have been brought before the shareholders beyond the mere fact that the accounts, as rendered, are correct. For our own part, we think it will not be necessary for an auditor to recount to the shareholders the various steps leading to his certification of the accounts. But if any outstanding points still remain in which there is a bona fide difference of opinion between the directors and the auditor, these will naturally very properly form the subject of a report to the shareholders. . . . Attention may also be profitably directed to the point raised by Mr. D. F. Basden, F.C.A., in his letter appearing in our last issue—namely, that the report mentioned in sect. 23 is to cover not merely the balance sheet laid before the company in general meeting, but also whatever accounts have been examined by the auditors.

"This presumably would include not merely the trading and profit and loss accounts (one or both of which might be appended to the published accounts) but also the actual accounts, or books of account of the company."

COUNSEL'S OPINION ON THE AUDIT PROVISIONS OF THE COMPANIES ACT, 1900.

The Council of the Institute of Chartered Accountants in England and Wales subsequently took the joint opinion of four eminent counsel. Paragraphs (5), (6) and (7) of that opinion read as follows :—

"(5) In our opinion the certificate and report referred to in sect. 23 must be separate and separately signed, even though both be placed on the balance sheet. There would, however, be no objection, if it be desired, to connect the certificate with the report by inserting in the certificate a reference to the 'subjoined' or 'accompanying' report; and, as an alternative, where thought expedient, the certificate might set out the report verbatim, thus : I certify, &c., and I report to the shareholders that, &c. Signed A.B. If, however, this course be adopted, it will, in our opinion, still be necessary that the auditor should make and sign the report separately, and send it in to the directors to be placed before the shareholders."

"(6) As regards the form of certificate, it may run thus :—

"*Auditor's Certificate.*

"In accordance with the provisions of the Companies Act, 1900, I certify that all my requirements as auditor have been complied with."

"And the report might run thus :—

"To the shareholders of the.....Company, Limited.

"*Auditor's Report.*

"I have audited the above balance sheet (or the company's balance sheet dated the..... day of .....) and in my opinion such balance sheet is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs, as shown by the books of the company."

"(7) Sect. 23 of the Act of 1900 requires the auditor to report whether the balance sheet is properly drawn up, so as to exhibit a true and correct view of the state of the company's affairs as shown by the books of the company. In our opinion these words, 'as shown by the books of the company,' do not limit the auditor's duties to a comparison of the figures. No doubt he has to examine the books; but, as Lord Justice Lindley said, *In re The London and General Bank* (1895, 2 Ch. 683) : 'He does not discharge his duty by doing this without inquiry, and without taking any trouble to see that the books themselves show the company's true position. He must take reasonable care to ascertain that they do so.'"

Although the Act of 1900 so clearly stated that the auditors "*shall make a report to the shareholders on the accounts examined by them*," it is significant that there is no reference whatsoever in the opinion to this very definite obligation. The opinion was accepted by the accountancy professon, however, as removing any doubts as to the proper interpretation of sect. 23 and it settled the duties of auditors under the 1900 Act, for auditors did not in practice make any reference in their reports to the profit and loss account or to any "accounts examined by them" other than the balance sheet.

MR. JUSTICE BUCKLEY ON THE AUDITOR'S REPORT, 1906.

In *Newton* v. *Birmingham Small Arms Company** in 1906 the Court granted an injunction restraining the defendant company from acting upon a special resolution which gave the directors power to set aside out of profits a sum or sums as an internal reserve fund, without disclosing to the shareholders the creation, existence, or application of such fund or the invest-

* *Newton* v. *Birmingham Small Arms Company* (1906, 2 Ch., 378).

ments representing it. In the course of his judgment, Mr. Justice Buckley said :—

"The concluding sentence of sect. 23 requires that the auditor shall state whether the balance sheet exhibits a true and correct view of the state of the company's affairs as shown by the books. Sir Robert Finlay argued that these words are satisfied if the auditors report that the balance sheet does not exhibit a true view and that the statute does not, in these words, say that they shall report what is the true view. This is logically true as regards the language, but, in my judgment, the statute is saved from the reproach of having achieved no more than this impotent result by words earlier in that section, which provide that the auditors are to report to the shareholders on the accounts. A report upon the accounts involves a report of the result of the accounts, and this necessarily involves, as matter of substance if not of form, the statement of a balance sheet or the equivalent of a balance sheet. There are, I agree, in the Act of 1900 no affirmative words to the effect of what I am about to state, but I think the language of the Act is sufficient to show that by implication it requires that there shall be annually an audit of accounts resulting in a balance sheet, to the accuracy of which the auditors shall speak. The special resolutions in the present case provide that the balance sheet shall not disclose the internal reserve fund. It must therefore omit on the assets side of the balance sheet the assets which make up the amount standing to the credit of that fund and the contra item—namely, the credit balance of the fund—on the liability side. The result will be to show the financial position of the company to be not as good as in fact it is. If the balance sheet be so worded as to show there is an undisclosed asset, whose existence makes the financial position better than shown, such a balance sheet will not, in my judgment, be necessarily inconsistent with the Act of Parliament. Assets are often, by reason of prudence, estimated and stated to be estimated, at less than their probably real value. The purpose of the balance sheet is primarily to show that the financial position of the company is at least as good as there stated, not to show that it is not or may not be better."

This judgment is of importance because it has often been quoted as giving judicial authority to the proposition that a balance sheet can properly be certified as true and correct, although it shows the position in a company as being not as good as it is in fact.

COMPANIES ACT, 1907 : DUTIES OF THE AUDITOR.

In 1907 another Companies Act was passed. The duty of the auditor is contained in sect. 19 (2), viz :—

"The auditors shall make a report to the shareholders on the accounts examined by them, and on every balance sheet laid before the company in general meeting during their tenure of office, and the report shall state :—

"(*a*) Whether or not they have obtained all the information and explanations they have required ; and

"(*b*) Whether, in their opinion, the balance sheet referred to in the report is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs according to the best of their information and the explanations given to them, and as shown by the books of the company."

It will be observed that there is little material difference in this section from the provisions of the 1900 Act. Although it had become almost the invariable practice for auditors to restrict their report to the balance sheet, the requirement to "report to the shareholders on the accounts examined by them" is repeated.

COUNSEL'S OPINION ON THE AUDIT PROVISIONS OF THE COMPANIES ACT, 1907.

Again, the Institute of Chartered Accountants took the opinion of four eminent counsel, from which I give the following extracts :—

"(1) In our opinion the auditors' report to be made pursuant to paragraph (2) of sect. 19 of the Companies Act, 1907, should, in cases where the auditors have no special comments to make, run as follows :—

"Report of the auditors to the shareholders of ..... Limited.

"We have audited the balance sheet of the ..... Limited, dated the ..... day of ..... (and here identify it as : 'above set forth,' or 'within contained,' or 'a copy of which is annexed hereto and initialled by us,' or 'a copy of which has been initialled by us').

"We have obtained all the information and explanations we have required.

"In our opinion such balance sheet is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs according to the best of our information and the explanations given us and as shown by the books of the company."

"(8) As to the general duties of the auditors, under sect. 19 of the Act of 1907, we consider that they should perform these duties with due regard to the provisions of the company's articles of association in so far as those articles are consistent with the Acts, and that they should call for all such information and explanations as they consider requisite to enable them to make the report to the shareholders contemplated by the section. They should not have the least hesitation in reporting fully as to any unsatisfactory features in the position. . . ."

This opinion conformed to the general practice which had obtained since the 1900 Act, in regard to the form and wording of auditors' reports and has been followed by the accountancy profession to the present time.

MR. JUSTICE ROMER ON THE AUDITOR'S DUTIES IN VERIFYING SECURITIES, 1924.

From 1907 until after the Great War, there was no alteration in company law or outstanding cases in

regard to accounts and audit. In 1921 the criminal trial of two of the directors and the auditor of Farrow's Bank, Limited, aroused widespread public interest, but no issues of importance to the accountancy profession were involved.

In 1922, there occurred the failure of the City Equitable Fire Insurance Company, Limited,* Its chief interest to the accountancy profession arose in 1924, when misfeasance proceedings were heard before Mr. Justice Romer, whose judgment was confirmed by the Court of Appeal.† The main issue was if the auditors had failed in their duty by reason of the fact that, instead of verifying securities by actual inspection, they had relied upon a certificate from the company's stockbrokers. In the course of a judgment of importance to practising accountants, Mr. Justice Romer said that it is the duty of a company's auditor in general to satisfy himself that the securities of the company in fact exist and are in safe custody, and he reviewed the circumstances in which an auditor might or might not be justified in accepting the certificates of banks or persons in whose possession such securities may have been placed. This view implies a responsibility which goes beyond the mere certification of the balance sheet.

INDEMNITY CLAUSES IN ARTICLES OF ASSOCIATION.

Mr. Justice Romer expressed the view that the auditors had committed a breach of duty, but gave judgment in their favour on the ground that they were entitled to the benefit of an indemnity clause in the articles of association. Such a clause was not uncommon in companies' articles and provided that the directors, auditors and other officers of the company should be indemnified against any loss or liability they may incur in connection with the carrying out of their duties, provided such loss or liability did not happen through their own wilful neglect or default.

COMPANIES ACT, 1929: IMPORTANT CHANGES IN, AND CONSOLIDATION OF, COMPANY LAW; EXTENDED ACCOUNT AND AUDIT PROVISIONS; OBLIGATORY PROFIT AND LOSS ACCOUNT.

The Company Law Amendment Committee appointed in 1925 expressed the view that the protection which an indemnity clause gave to auditors was unwarranted and should be forbidden. This was given effect to in the Companies Act of 1928, which made important changes in the law as to accounts but did not come into force, in so far as it dealt with accounts and audit, until the Consolidating Act of 1929. For the first time, provisions were included as to the form and contents of the balance sheet, and that a profit and loss account or income and expenditure account must be submitted to shareholders. The duties of an auditor were set out in sect. 134 (1), which was practically identical with sect. 19 (1) of the 1907 Act previously quoted.

* *In re City Equitable Fire Insurance Company, Limited* (1925, Ch., 407).

† The case of the *London and General Bank*, nearly 30 years earlier, was relied on as defining the duties and responsibilities of auditors.

TRIAL OF CHAIRMAN AND AUDITOR OF ROYAL MAIL STEAM PACKET COMPANY, 1931: FORM AND CONTENTS OF PROFIT AND LOSS ACCOUNT.

No trial affecting the liability of an auditor has aroused such intense interest within the accountancy profession as the criminal proceedings against the chairman and auditor of the Royal Mail Steam Packet Company* in 1931. The company, which was one of the largest and most important in this country, had been constituted under a series of Royal Charters, the first of which was granted in 1839, and the auditor charged was a partner in one of the largest firms of accountants in the world. The Royal Mail Steam Packet Company was the head of the leading group of shipping companies in the Kingdom. The group consisted of some 35 companies, in six of which, frequently referred to during the trial, the Royal Mail Company owned the whole of the share capital. The accounts were extremely intricate and required close investigation to arrive at a clear comprehension of the matters involved.

(*a*) *Evidence at the Trial.*

The case of the Crown was that in the year 1923 there existed very substantial reserves undisclosed to the shareholders, resulting from the liability of the company to excess profits duty being settled, chiefly by reason of allowances for obsolescence and deferred repairs, at considerably less than the previously estimated amount as provided for in the accounts; that these "old" reserves were utilised in subsequent years to build up substantial profits, which were shown in the profit and loss accounts without clear information as to their abnormal nature; and that the profit and loss accounts consequently conveyed the impression that the company was prosperous, when in fact actual losses on trading were being experienced. It appeared from the evidence, however, that the liability to excess profits duty was not finally settled until 1927, and nearly all of the accountant witnesses, some of them called by the prosecution, expressed the opinion that it would not have been sound and proper to have taken these credits in respect of excess profits duty to profit and loss account and so have treated them as available for dividend in any years earlier than those in which they were appropriated for such purpose. Evidence was given that similar transfers to the credit of profit and loss account had been made in the case of some of the subsidiary companies, whose balance sheets had been certified by well-known accountancy firms, and whose position in regard to excess profits duty was analogous to that of the Royal Mail Company. Further than this, there was a number of accountants, some of them well known, engaged in the case on behalf of the defence, who carefully investigated the accounts and supported the view expressed by the accountant witnesses, that the excess profits duty credits had been transferred to profit and loss account in the proper years. This being so, it followed that in the balance sheets of the Royal Mail Company from 1923

* *R.* v. *Kylsant and Morland.* Reported in *the Incorporated Accountants' Journal, August*, 1931, and in "The Royal Mail Case" (Notable British Trials).

to 1927 there were no undisclosed "free" reserves, although there did exist sources from which the company did eventually derive substantial benefits, which, when they materialised by actual receipt, became profit available for dividend. Little exception was taken to the balance sheets, which were not strongly challenged even by the prosecution. In no year was the actual position less favourable than that disclosed and the balances properly available as dividend to the credit of profit and loss account were not incorrect.

(b) Importance of the Trial to Auditors.

The trial really concerned the form and contents of the profit and loss account and the inclusion therein of what the prosecution contended were "old" reserves without disclosure of the fact and the amounts involved, with the result that false impressions were conveyed as to the results of the company's business. The Royal Mail Company had for years followed the practice, by no means uncommon, of giving practically no information whatsoever in the profit and loss account regarding its expenditure, or the details of its profits and revenue, but showed only the net result in one conglomerate item. At the instance of the auditor, however, there had been inserted in the profit and loss accounts for 1926 and 1927, the years in respect of which the charges were brought, the words "adjustment of taxation reserves." It may be argued that this phrase should have been a clear indication that the balances on the profit and loss account were affected by an abnormal credit and, from the very fact of the insertion of the words, that the amount involved was material. There may be differences of opinion regarding the course adopted by the auditor, but practising accountants generally had not the slightest doubt as to the baselessness of a criminal charge. The verdict of the jury, wholly in favour of the auditor, was received with satisfaction by everyone having the interests of the accountancy profession at heart, but the trial emphasised the weakness in the prevailing practice relating to the published balance sheets and accounts of public companies and caused no little uneasiness as to the extent of the responsibilities of auditors. Very considerable controversy has taken place amongst members of the accountancy profession in this and other countries, particularly as to, firstly, the propriety of undisclosed or secret reserves, and secondly, the form and contents of the profit and loss account.

On these two subjects much has been said and written by prominent members of our profession and numerous articles have appeared in the accountancy publications and the leading daily and financial newspapers and periodicals. There has been so much divergence of opinion that I want to make it quite clear I am not attempting to define the attitude of the British accountancy profession in these matters. I am expressing my own personal opinions. Views, however, have been clarified since 1931 and there is a tendency to make the published accounts of many public companies more informative.

(c) Mr. Justice Wright on Secret Reserves.

In his address to the jury in the *Royal Mail* trial, Mr. Justice Wright made the following observations on the subject of Secret Reserves:—

> "We have heard a great deal about the keeping of secret reserves, and we have heard a great deal about the commercial troubles which may flow from that practice. We have heard a great deal about what is often done in practice, and it may be reasonably and properly done, but the question may arise some day, and possibly will arise, in some appropriate proceeding, in order to find out and elucidate these very special matters. It was said by a very learned judge on one occasion, by way of observation and not by judgment, that a company, that is to say the shareholders, could not complain if the position of the finances of the company was better than the accounts disclosed. That has been quoted from time to time as a justification for this method of keeping reserves secret. But there may be very great evils if those who have the control and management of the companies, and who control and manage companies for the benefit of the shareholders who entrust their moneys to companies, have very large portions of the company's assets left in the secret disposition of the managing authority. It may work very well in many cases; no doubt it does. It is a practice which is being followed, no doubt, by many concerns of the highest standing. On the other hand, it may be the subject of almost intolerable abuse. Such a system may be used to cover up negligences, irregularities, and almost breaches of faith. It is said to be a matter of domestic concern between the company and the shareholders, but if shareholders do not know and cannot know what the position is, how can they form any view about it at all?"

AUDITOR'S DUTY IN RELATION TO SECRET RESERVES.

In November, 1931, when I was President of the Society of Incorporated Accountants and Auditors, I spoke upon the question of Secret Reserves, and said, *inter alia*:—

> "It should be borne in mind that a secret reserve can arise only through an under-statement of profit and in no other way, and it cannot be denied that balance sheets or profit and loss accounts which are affected by secret reserves are untrue to the extent of such reserves. . . .
>
> "I am aware that among practising accountants there is a considerable divergence of opinion regarding the propriety of secret reserves. I have heard leading accountants express the view that provided the creation, existence or utilisation of a reserve is noted in the accounts the non-disclosure of the actual amount is justifiable, but it is my personal opinion that it is is not consistent with the statutory form of the auditor's certificate, which in such case I consider should be qualified by the use of words such as 'subject to the non-disclosure of the amount of the reserve referred to in the balance sheet or profit and loss account' as the case may be."

AUDITOR'S DUTY IN RELATION TO GROUPED ITEMS IN THE PROFIT AND LOSS ACCOUNT.

In December, 1931, in emphasising the importance of the profit and loss account, I deprecated the practice (not infrequently followed) of "grouping in one item, profit on trading, income from investments and properties, royalties and revenue and profits from every source, even though of an abnormal or temporary character," and concluded by suggesting that "the auditor's responsibility for the profit and loss account should be placed beyond question and his certificate should be extended by the addition of some such phrase as 'the profit and loss account is a true and correct statement showing the profit earned (or loss incurred) during the period covered by that account.'"

COUNSEL'S OPINIONS ON RESERVES, 1931.

In December, 1931, the Insitute of Chartered Accountants issued to its members the opinion of Mr. Wilfrid Greene, K.C., and Mr. Cecil W. Turner on the question as to whether that body could properly and usefully issue any form of general pronouncement for the guidance of their members on the questions and matters discussed in the recent trial arising out of the affairs of the Royal Mail Steam Packet Company. The opinion was to the effect that no such pronouncement was really feasible. After giving their reasons, counsel referred to what are often termed "secret" or "undisclosed" or "inner" reserves in the following terms:—

> "When these expressions are examined, it becomes apparent that they are not expressions which have a clear and well defined meaning, and that they, or one or more of them, may be applied to a number of different types of reserve. Probably even experienced accountants would not all agree as to their exact scope and meaning. It follows, therefore, that a general proposition which might be applicable to one type of 'secret' reserve might not be equally applicable to another, or that a given proposition might be applicable to a flagrant or extreme case, though not to one where no 'misleading' was involved."

PROPRIETY AND UTILISATION OF SECRET RESERVES.

Much more helpful to members of the accountancy profession were the views expressed by Lord Plender in a paper read by him in February, 1932, when he said:—

> "Inner or secret reserves and their propriety—if not legality—have recently been the subject of judicial comment. Such reserves may exist, for example, in the excessive writing down of the book values of assets, in under-valuation of investments, or in provisions for contingencies the amount of which is not specifically set out on the balance sheet. In my opinion directors should be entitled, in the interests of a company and its shareholders, to make reasonable provisions for contingencies and should be allowed discretion in so doing without necessarily being required to disclose the amount of the provisions in the balance sheet. . . The reserve for contingencies is generally included in an omnibus item on the liabilities side of the balance sheet (such as 'creditors including provision for contingencies') and in my view it is necessary that its existence should be indicated by suitable wording. The use of such reserves in relief of losses or by way of supplement to profits should, I think, be indicated to the shareholders, and except in comparatively rare cases the amount so used should be stated. The origin and utilisation of undisclosed reserves covers such a wide field of circumstances that it is not possible to dogmatise on the question, and a decision as to the right course to pursue can only be arrived at after a full consideration of the facts in each individual case."

This statement, which had been preceded by considerable discussion in the Press as to the utilisation of undisclosed reserves in relation to the profit and loss account, certainly had some influence on practice, for certain well-known companies disclosed in their profit and loss accounts the inclusion of reserves or provisions no longer required from previous years. Amongst accountants there must be agreement that the use of undisclosed reserves should be indicated and that the amounts should generally be stated if the profit and loss account is to show the profit-earning capacity of a company. If, however, it is accepted that the *utilisation* of reserves and of surplus provisions made in an earlier year must be disclosed, then there can be little advantage in *creating* reserves without disclosure, and whatever argument may be advanced in favour of non-disclosure on the ground of expediency, it cannot be contended that it is strictly in accord with sound accountancy principles.

NECESSITY TO DISCLOSE CERTAIN RESERVES IN ACCOUNTS.

Although circumstances might arise that would justify or necessitate a provision for "contingencies," the non-disclosure in a balance sheet of a "free" reserve, in its true sense, can be made only with the object of creating in the minds of shareholders or the public the impression that the company's affairs are in a position which is not in accordance with the facts. There may be no wrong intention on the part of the directors, who may think they are acting in the best interests of the company, but such a balance sheet should not, in my opinion, bear an auditor's unqualified report as to its truth and correctness. If the actual amount of a secret reserve is immaterial, there cannot be any real object in creating it; if it is material, I fail to see how its non-disclosure can be defended.

DIFFERENT KINDS OF RESERVES.

No little confusion has been caused by the loose and indiscriminate way in which the word "reserve" has been used in connection with accounts. It is most frequently accompanied by a qualifying word or expression, as in "reserve for accrued liabilities," "reserve for bad debts," "stock reserve," "reserve for loss on exchange," "reserve for depreciation," "leasehold depreciation reserve," or "reserve for income tax." Ordinarily the character of these items is such that they have to be taken into account in arriving at the profit or loss and no objection could reasonably be taken to their non-disclosure. If

accountants would adopt the practice of calling them "provisions"—which, in fact, they are—much misunderstanding would be avoided. In addition, we may have a "general reserve," "capital reserve," "reserve for equalisation of dividends," or "debenture redemption reserve." These are reserves in the true sense of the term; they originate most frequently from an appropriation of profit and are almost invariably set out clearly in balance sheets. Further, we may have an "internal reserve" or a "reserve for contingencies." In many cases such reserves if undisclosed would be synonymous with the term "secret reserve."

I want to make it clear that in the term "secret reserve" I do not include the making of proper provisions for estimated losses or expenses not definitely ascertainable at the date of making up the accounts. I mean undisclosed reserves which arise from an under-statement of profit. "Secret reserves" as long as they exist, affect the balance sheet, in which they may be reflected by over-stating liabilities or by under-valuing assets, but they do not affect the profit and loss account except in the periods when they originate or when they are utilised to increase the profit or reduce the loss.

CONTENTS OF BALANCE SHEETS UNDER COMPANIES ACT, 1929.

The Companies Act of 1929 strengthened the position of the auditor in relation to the balance sheet by including provisions as to its contents. Sects. 124 and 125 read as follows:—

"124. (1) Every balance sheet of a company shall contain a summary of the authorised share capital and of the issued share capital of the company, its liabilities and its assets, together with such particulars as are necessary to disclose the general nature of the liabilities and the assets of the company and to distinguish between the amounts respectively of the fixed assets and of the floating assets, and shall state how the values of the fixed assets have been arrived at.

"(2) There shall be stated under separate headings in the balance sheet so far as they are not written off:—

"(*a*) The preliminary expenses of the company; and

"(*b*) Any expenses incurred in connection with any issue of share capital or debentures; and

"(*c*) If it is shown as a separate item in or is otherwise ascertainable from the books of the company, or from any contract for the sale or purchase of any property to be acquired by the company, or from any documents in the possession of the company relating to the stamp duty payable in respect of any such contract or the conveyance of any such property, the amount of the goodwill and of any patents and trade marks as so shown or ascertained.

"(3) Where any liability of the company is secured otherwise than by operation of law on any assets of the company, the balance sheet shall include a statement that that liability is so secured, but it shall not be necessary to specify in the balance sheet the assets on which the liability is secured.

"(4) The provisions of this section are in addition to other provisions of this Act requiring other matters to be stated in balance sheets."

"125. Where any of the assets of a company consist of shares in, or amounts owing (whether on account of a loan or otherwise) from a subsidiary company or subsidiary companies, the aggregate amount of those assets, distinguishing shares and indebtedness, shall be set out in the balance sheet of the first-mentioned company separately from all its other assets, and where a company is indebted, whether on account of a loan or otherwise, to a subsidiary company or subsidiary companies, the aggregate amount of that indebtedness shall be set out in the balance sheet of that company separately from all its other liabilities."

DISCLOSURE OF LOANS TO DIRECTORS AND OFFICERS AND REMUNERATION OF DIRECTORS.

The 1929 Act provides that the accounts to be laid before every company in general meeting shall contain certain particulars relating to loans to any director or officer of the company, and remuneration paid to directors. The obligation to furnish these particulars rests primarily upon the directors, for sect. 128 (4) reads as follows:—

"128. (4) If in the case of any such accounts as aforesaid the requirements of this section are not complied with, it shall be the duty of the auditors of the company by whom the accounts are examined to include in their report on the balance sheet of the company, so far as they are reasonably able to do so, a statement giving the required particulars."

CONDITIONS TO BE SATISFIED BY THE BALANCE SHEET.

Strictly speaking, the settlement of the form and contents of the balance sheet is the responsibility of the directors and the auditor's function is restricted to reporting upon it. In practice, however, the balance sheet is almost invariably submitted to the auditor for his approval before it is finally settled in order to avoid qualifications in his report.

I suggest that before an auditor would be justified in making an unqualified report in accordance with the wording of the Companies Act, 1929, the balance sheet should satisfy the following conditions:—

(1) It should be properly drawn up.
(2) It should be true.
(3) It should be correctly stated.
(4) It should be in accordance with the books.
(5) It must not convey a misleading impression as to the state of affairs of the company.

The first, second and fourth of these conditions should not present any special difficulties, and if the first four are complied with, the last would almost certainly be fulfilled.

Before the Companies Act of 1929, it might have been largely a matter of opinion if a balance sheet was

"properly drawn up," but as sects. 124 and 125 of that Act specify the form and contents of the balance sheet, a balance sheet would generally be regarded as "properly drawn up" if the requirements of these sections are complied with. If what is stated in a balance sheet is true and if a balance sheet is in accordance with the books, are generally questions of fact and capable of verification, but the difficulty arises when the auditor has to decide if the various items are *correctly stated*, since this is frequently a matter of opinion. Before a balance sheet can be regarded as correctly stated, it must conform to sound accountancy principles. What is true is not necessarily correctly stated: for instance, it may be true to state that stock is taken at cost, but it would not usually be correct to state it so, if at the date of the balance sheet there had been a fall in market value. Again, if shares in a subsidiary company were shown "at cost," it would be true, but if a part of the capital of such subsidiary company had been lost, judged by sound commercial and accountancy principles, the item would not be correctly stated. It is my view that, if the losses of a subsidiary are not dealt with by reducing the amount at which the investment appears or by making proper provision on the liabilities side of the balance sheet, the auditor should call attention thereto in his report.

If a balance sheet does not comply with the five conditions which I have enumerated, it becomes the duty of the auditor to call attention in his report to the shareholders to any omission and to any and every item to which he takes exception. The wording employed should be sufficiently clear and definite to avoid misunderstanding, but it is not part of the auditor's duty actually to rectify any misstatement or omission in the balance sheet, or to express his opinion as to the amount that is involved thereby.

IMPORTANCE OF EARNING CAPACITY IN PROFIT AND LOSS ACCOUNTS.

I have mentioned it was not until the Companies Act of 1929 that there were any provisions requiring that a profit and loss account should be submitted to shareholders. I cannot trace that the expression "profit and loss account" appeared in any of the Companies Acts prior to 1928. Further, in reports of the leading cases regarding the duties of auditors practically no references to the profit and loss account appear and the judgments have dealt with the auditor's obligations in relation to the balance sheet. An outstanding feature of the *Royal Mail* trial was that it was the first case of importance in the English Civil or Criminal Courts in which the auditor's responsibility for the profit and loss account had been raised. This is surprising in view of the increasing attention which has been directed to earning capacity, upon which share values are largely based. The importance of earning capacity in relation to capital asset values was clearly expressed by Lord Plender in the paper to which I have referred and from which I again quote :—

"As regards the profit and loss account, it may be found that in a number of instances the information given in this account, however abbreviated in form, is of as much value to the shareholder in affording a guide to the company's position and progress as the information in the balance sheet, however much greater in volume the latter information may be. After all, the value of the assets of a business, considered as a whole, really depends on what they are capable of earning in the form of annual profits; and consequently the figure of net profit which should be shown in a profit and loss account, when considered in conjunction with similar figures relating to previous financial years, may give the shareholder a fairly true indication of the real value of the enterprise which the company owns. I am, of course, speaking in very general terms."

Lord Plender very truly added that "Whatever the book value of fixed assets may be, their real value lies—with certain exceptions—in their earning capacity." It is, therefore, not too much to say that a balance sheet which includes fixed assets such as factories, plant and machinery, may be of little, if any, value as exhibiting a true and correctly stated view of the company's affairs, unless it is accompanied by a true and correct statement of profit-earning capacity. In the case of many companies, their solvency must be dependent on their continuing capacity to earn profits.

If further proof were required of the importance of the profit and loss account, one need only examine the publications which review the reports and accounts of public companies. The particulars which are invariably set out relate not only to the balance sheet but to the profit or loss for the year and the appropriation of the profit. A governing factor in estimating the value of a company's shares is the earning capacity in relation to the capital and, therefore, the profit and loss account is a very important account to the shareholder.

AUDITOR'S OBLIGATION TO REPORT ON PROFIT AND LOSS ACCOUNTS UNDER THE COMPANIES ACT, 1929.

In considering the auditor's responsibility in relation to the balance sheet we are greatly assisted, firstly, by the provisions of the Companies Acts, in which the auditor's responsibility and duties are laid down; secondly, by numerous judgments in cases decided in the Courts, some of which I have already referred to; and, thirdly, by practice, which to a large extent may be regarded as well established. In the case of the profit and loss account, however, no such extensive assistance is available. The Companies Act of 1929, in first referring to the profit and loss account, gave no indication as to its form and contents or the function it is intended to serve. I have mentioned that until the *Royal Mail* trial, there do not appear ever to have been any proceedings in the Civil or Criminal Courts as to the responsibility of an auditor in relation to the profit and loss account and I have not observed in the published reports of the auditors of public companies that exception has been taken, or even reference made, to the form and contents of the profit and loss account or the result which it shows. In practically every case which I

have examined, any qualification in the auditors' report has had reference to the balance sheet.

The opinion of counsel to which I have referred, arising from the *Royal Mail* case, concluded with the following reference to the profit and loss account :—

> "We have been asked whether the duties and responsibilities of an auditor extend to the profit and loss account, though it is not specifically reported upon to the members of a company. In our opinion having regard to the fact that the balance sheet contains as one of its items the balance brought in from the profit and loss account, they cannot dissociate themselves from all responsibility for the correctness of that account and there may be cases in which it would be incumbent upon them to draw the attention of the shareholders to any feature of that account which in their view involved anything of any improper or misleading character."

I agree with the conclusions of counsel as to the obligations of an auditor in relation to the profit and loss account, but I consider such obligation to be directly imposed by the Act and not arising, as they indicate, by implication. The 1929 Act provides for the submission to shareholders of a profit and loss account, and surely an auditor should examine with the greatest care an account which the law requires to be placed before the owners of the company. The first duty of the auditor is to "make a report to the shareholders on the accounts examined by him," and it is difficult, therefore, to see how it could logically be contended that the Companies Act does not impose upon the auditor a definite obligation to report on the profit and loss account and most certainly so if in any respect it is untrue, incorrectly stated or misleading.

However, whether the auditor's responsibility for the profit and loss account is definitely imposed by the Companies Act or whether it arises by implication owing to the inclusion of the balance of the profit and loss account in the balance sheet, the responsibility certainly exists.

NATURE OF THE PROFIT AND LOSS ACCOUNT.

The term "profit and loss account" in the system of double-entry bookkeeping is the title of one of the nominal accounts in the books of all companies trading for profit. It is made up of debit and credit balances transferred from other nominal accounts and the resulting balance represents the profit or loss for the period. This, of course, is elementary and is well understood by accountants, book-keepers and business men. The profit and loss account being part of the bookkeeping system, and not, like the balance sheet, a summarised statement of all the balances in the books after they have been closed, one might have expected that the Act would have referred to *the* profit and loss account or to a statement or summary of *the* profit and loss account. The Act refers, however, to *a* profit and loss account and from this it is to be inferred that considerable latitude is given as to what information and particulars in the profit and loss account, as it appears in the books, should be included in the profit and loss account required by the Act. In practice the profit and loss account issued to shareholders bears little resemblance to the account in the books, for almost invariably there are omitted all particulars of the trading and practically all items of expenditure.

FUNCTION OF THE PROFIT AND LOSS ACCOUNT.

The function of a profit and loss account is to show the profit earned or loss suffered by a company during the period which such account is expressed to cover. This is undoubtedly its function in the view of shareholders, but the law requires the balance shown to the credit of the profit and loss account to be the amount properly available for distribution as dividend, and we know that such balance may differ greatly from the actual trading results for the period.

FORM AND CONTENTS OF THE PROFIT AND LOSS ACCOUNT.

If it were intended by the Act that the profit and loss account need do no more than disclose the balance available for dividend, it would be of little value to shareholders, for such information could usually be ascertained from the profit and loss item in the balance sheet. The varieties of businesses carried on by companies are so numerous and complex that anything in the nature of uniformity in form and contents in the account is obviously impossible, whilst directors, for reasons quite proper and understandable, are usually opposed to unnecessary disclosure of detailed information regarding the businesses of the companies which they administer. It is generally agreed that the *extent* of the information to be disclosed must largely remain a matter as between directors and shareholders and that an obligation to include particulars of an internal nature would in many cases operate greatly to the detriment of the interests of shareholders. If, however, the profit and loss account is to be of value to shareholders and the risk of their being misled is to be avoided, certain general principles must be observed. Surely there should be little difficulty and not much difference of opinion amongst accountants, in deciding what those general principles should be.

RECOMMENDATIONS OF THE SOCIETY OF INCORPORATED ACCOUNTANTS AND AUDITORS REGARDING THE PROFIT AND LOSS ACCOUNT.

The only pronouncement by any professional body regarding the profit and loss account was made in April, 1932, by the Society of Incorporated Accountants and Auditors. In November, 1931, the Council of the Society appointed a committee to consider and report whether in their opinion any amendment of the law was deemed necessary and/or what, if any, alterations of a voluntary character may be considered desirable in the compilation of company accounts or their certification by professional auditors. That committee reported in favour of amending legislation and indicated what alterations should be made. The profit and loss account was dealt with in the first two paragraphs of Clause 5 of the report, which read as follows :—

> "(*a*) That the profit and loss account should

show the true balance of profit or loss for the period covered by such account.

"(*b*) That in the profit and loss account any debits or credits which are abnormal in character or extraneous in their nature to the ordinary transactions of the company, together with any reserves from a previous period no longer required, should be stated separately."

In the first paragraph there is the enunciation of a principle with which few, if any, members of the accountancy profession will disagree; in the second, there are set out certain matters which should be stated in the profit and loss account to ensure adherence to the principles of paragraph 1. I ought to add, however, that some directors and others responsible for the management of public companies, would assert that compulsion to adhere to this principle in all circumstances would not be in the best interests of shareholders. One aspect of this particular problem is referred to in paragraph 6 of the report, which recognised certain difficulties in giving effect to the recommendations of the committee in the case of banking and similar institutions, such as discount houses and the like. The committee felt, however, "that the paramount consideration is the maintenance of public confidence in the administration of industrial, commercial and financial undertakings."

In the profit and loss account the directors' remuneration required by law to be disclosed is usually stated as a separate item. In my opinion, it is desirable that the profit and loss account should also include, as separate items on the debit side, interest on loans or loan capital and income tax—both of which are somewhat in the nature of appropriations of profit—and, on the credit side, income from property or assets not used in connection with the carrying on of the company's business, such as outside investments.

It is the usual practice to aggregate the profits of, or the income from, subsidiary companies with the results of the holding company's business, and this practice is sound and proper since subsidiary companies are most frequently branches or departments of the holding company. Profits of subsidiaries are generally capable of regulation at the instance of the holding company, according to the basis of inter-company transactions, and no useful purpose would be served by showing the profits or dividends of subsidiaries as separate items.

CONDITIONS TO BE SATISFIED BY THE PROFIT AND LOSS ACCOUNT.

I maintain that we should apply to the profit and loss account, a standard no lower than that of the balance sheet. The profit and loss account would then have to satisfy the following conditions:—

(1) It should be true.

(2) It should be correctly stated.

(3) It must not convey a misleading impression as to the results of the company's business.

In the *Royal Mail* case the impressions conveyed by the profit and loss account constituted the foundation for criminal charges, and that such charges could have been brought at all establishes conclusively that the responsibility of the auditor in relation to that account is a very real and serious one. The law regarding the duties and powers of an auditor is of little value, however, whilst counsel's opinion arising from the *Royal Mail* case has disturbed and perplexed many members of the accountancy profession.

I think that most accountants to-day would agree that if *any* feature of the profit and loss account involved *anything* of an improper or misleading character, it would be the auditor's duty to draw attention to it in his report. What we should regard as being improper or misleading, however, presents a problem of no little difficulty, having regard to current law and practice, especially in regard to holding and subsidiary companies. There is no doubt that the great majority of shareholders regard the balance shown by the profit and loss account as representing the actual result for the period covered by the account, and it follows that, unless it is clearly shown in what respects and to what extent the balance shown differs from the actual earnings, the profit and loss account is apt to be misleading to the majority of shareholders.

AUDITOR'S RESPONSIBILITY FOR THE SOUND AND PROPER TREATMENT OF THE RESULTS OF SUBSIDIARY COMPANIES IN THE ACCOUNTS OF THE HOLDING COMPANY.

Unless the results of subsidiary companies are soundly and properly dealt with in the accounts of the holding company, such accounts may convey entirely wrong impressions.

If the profit and loss account of a holding company does not reflect the correct result of the business as a whole, I am of opinion it is the duty of the auditor to draw the attention of shareholders thereto in his report.

The provisions of the 1929 Act, however, as to the inclusion of the results of subsidiary companies in the accounts of the holding company, have been generally criticised and, from the accountancy standpoint, are unsatisfactory. Sect. 126 provides for disclosure as to how the profits and losses of subsidiary companies have been dealt with in, or for the purposes of, the accounts of the holding company and there is a proviso that it shall not be necessary to specify the actual amount of profits or losses of any subsidiary companies which have been dealt with in any particular manner. It should be noted that the section recognises the dependence of the results of a holding company's business upon the profits or losses of its subsidiaries.

The statement as to how the profits and losses of subsidiary companies have been dealt with has to be signed by the directors. Can it be said, therefore, that the auditor can "dissociate himself from all responsibility" in relation to the account upon which such statement is based? The unsound treatment of the results of subsidiaries in the accounts of a holding company may cause the profit and loss account to give a misleading impression as to the actual results

of the holding company's business. A person with an expert knowledge of accounts would infer from the kind of directors' statement which is so frequently appended to accounts to comply with Section 126, that the profit and loss account of the holding company cannot be relied on as indicating the earning capacity for the period covered by the account. But such inference would not necessarily be drawn by the "ordinary" shareholder, who would conclude that the balance of profit and loss account if described therein as "net profit" and referred to as such by the directors in their report, actually represented the profit earned during the year.

Surely it is not contended, because sect. 126 requires disclosure as to *how* the profits or losses of subsidiaries have been dealt with, that there is no obligation to see that they have been dealt with on sound and proper lines for the purposes of the accounts of the holding company. Consider the case of a holding company whose statement regarding its subsidiaries is in a form very frequently adopted, namely, "that the profits of subsidiary companies have been included in the profit and loss account to the extent of dividends declared." If it has been the practice of the subsidiary companies to declare dividends approximating to the profit earned each year—which is a sound practice—the profit and loss account of the holding company would show the correct result of the holding company and its subsidiaries as a whole. If, however, the dividends of the subsidiaries arise from profits earned in past years, which have been held up and carried forward in the accounts of the subsidiaries, then the profit and loss account of the holding company would convey a misleading impression as to the profit earned during the period covered by the account.

BALANCE SHEET AND PROFIT AND LOSS ACCOUNT ARE COMPLEMENTARY AND THE AUDITOR'S DUTY EXTENDS TO BOTH.

Some members of the accountancy profession may consider that the personal views I have expressed regarding the duties of an auditor go beyond what can reasonably be expected in actual practice. I cannot see that there is greater responsibility in expressing an opinion as to whether the profit and loss account conveys a true and correct impression of the result of a company's business, than in expressing an opinion as to whether the balance sheet shows a true and correct view of the state of its affairs. It may be an additional, but it is not, I maintain, a *greater* responsibility and any difficulties must generally be common both to the balance sheet and the profit and loss account, because the one is the complement of the other. If the balance sheet is true and correctly stated the profit and loss account will convey a true and correct impression, provided abnormal, extraneous and non-recurrent items are separately stated and the results of subsidiary companies are properly treated.

NATURE OF AMENDING LEGISLATION REQUIRED.

Accountants cannot ignore the fact that the ineffective provisions of the Companies Act regarding subsidiary companies, and the considerable extension of the group system and the subsidiary company principle, have had the effect of making the accounts of public companies far less informative and less reliable than they were 20 years ago. The remedy for this unsatisfactory state of affairs is suggested in the concluding paragraph of the report of the Society of Incorporated Accountants and Auditors, which reads :—

> "We do not consider it desirable to make any recommendations for alterations of a voluntary character in the compilation and/or certification of company accounts, since in dealing with such alterations auditors might be placed in a difficult position in regard to the law as it now stands. The only effective action must be by amending legislation."

In my opinion, the power of the auditor should be strengthened by amending the Companies Act of 1929 in regard to :—

(1) The profit and loss account ;
(2) The duties of the auditor ; and
(3) The treatment of subsidiary companies in connection with the accounts of holding companies.

I fully recognise the difficulty, the undesirability, indeed, I might say the impossibility, of laying down conditions regarding the actual form and contents of the profit and loss account, but it is not beyond the capacity of the accountancy profession to define general principles which would minimise the risk of shareholders and the public being misled. In the profit and loss account there should not be included *without disclosure* any sums which do not relate to the trading operations for the period, either directly or through the medium of subsidiary companies.

The duties of the auditor regarding the profit and loss account should be defined as in the case of the balance sheet. Responsibility for the profit and loss account certainly exists, and to discharge it the auditor should be required to report specifically on the profit and loss account as well as on the balance sheet. The public is entitled to the valuable protection which would be afforded by enacting, in effect, that the auditor's report should relate to all accounts required to be submitted to shareholders.

There appears to be general agreement as to the unsatisfactory character of the law relating to the treatment of subsidiary companies in connection with the accounts of holding companies. In amending legislation, provisions should be made to ensure adherence to sound accountancy principles and to prevent subsidiary companies being used for the purpose of withholding information which the holding company would have to disclose.

Amendment of the Companies Act is being urged in several responsible quarters and it is certain that some material alterations will be introduced regarding accounts and audit. Although the directors of the great majority of public companies do not restrict themselves to the observance of the strict letter of the law, but present their accounts in a form to which no exception can be taken, there is still a large number

of cases, principally amongst companies engaged in productive and trading businesses, where the published accounts are uninformative, frequently unreliable, and occasionally even misleading, in spite of the fact that the actual requirements of the Companies Act may have been complied with.

The accountancy profession stands high in the estimation of the public. We have been described as "the watchdogs of the shareholders" and great reliance is placed by the investing public on the accounts which we certify. Our responsibility is great and serious and to maintain the confidence we enjoy, we must use our influence, and direct our efforts, to securing such improvement in the law and practice of accountancy as will ensure that the accounts which we audit are true and correct and are sufficiently informative to prevent misleading impressions being conveyed as to the state of affairs of a company and the result of its operations.

There followed another Paper on the same subject from

THE CONTINENTAL POINT OF VIEW

BY

Dr. WILHELM VOSS

(Wirtschaftprüfer).

Dr. Voss said :—

The subject which I propose to discuss has been on the agenda of every International Congress of Accountants. It continually forms the central theme of all discussions affecting our profession, particularly when we are discussing the certification of balance sheets, or secret reserves, professional practice generally or any other isue of practical importance. And there is good reason for this. In the last analysis the justification for the existence of our profession depends on the amount of responsibility which we bear for our audit work, or, in other words, the extent to which we are willing or able to bear responsibility for our work.

It need scarcely be mentioned that the "safety first" point of view cannot be the decisive factor here. We know that in our profession we have got to take responsibility, but there should be complete clearness within and without our profession on the following points :—

(1) What principles determine our responsibility.

(2) Within the scope of these principles, what rules determine the limits of the degree of responsibility—

  (*a*) That should be expected of us, and

  (*b*) That we can bear in the extreme case.

I.

SOME ASPECTS OF THE PROBLEM.

My task is to discuss in this paper our subject particularly from the Continental standpoint. Incidentally I would remark that I do not think that the *principles* regarding our responsibility are really different in the various countries. In my view, Professor Limperg was right when he observed in his paper read before the Amsterdam Congress of Accountants that it is not the instructions of the client that should be decisive in measuring our responsibility but the purpose for which the audit is being carried out, and this purpose is fundamentally the same in the case of the normal audit of the annual accounts of a company in Holland, the United States, Great Britain, Germany or in any other country.

On the other hand the *rules* which within the scope of these principles define the limits of our responsibility, either extending or contracting these limits, are not identical in every country. They depend on the legal system of the particular country and on the degree of development and general standing of the profession of that country and on many other factors.

How then do matters stand in regard to the responsibility of our profession for annual accounts *on the European Continent*? The differences are actually very substantial, particularly in reference to the legal enactments. For instance, in some parts of Europe a compulsory audit of the annual accounts is not prescribed at all, in others, it is not undertaken by professional accountants: the scope of the audit is also by no means uniformly laid down in every country: in some cases we find extremely detailed regulations, in others, only generalised instructions, and again in others, special provisions regarding the responsibility of the auditor. In these circumstances I do not think it will serve any useful purpose to describe the legal or the actual position of our profession in the various Continental countries. The result would be to give a blurred picture of the whole, particularly since in almost all Continental countries the development of our profession has by no means ceased, and as there are movements on foot in nearly all countries to define afresh the standing and functions of our profession. I have, therefore, good reasons for limiting my subject and for dealing in a more detailed manner with the conditions in Germany. Though I deal with the matter mainly from the German standpoint I think it is fair to say that the remarks which follow are substantially equally applicable to the remaining Continental countries, as far as concerns the basic questions of professional conduct, though, of course, each country has its own system of law for dealing with these matters.

I must also limit my subject in one further direction. We are only discussing the responsibility for the normal audit of the annual accounts. I, therefore, do not discuss further matters which would be of importance in considering the preparation and audit of accounts for special purposes, *e.g.* for borrowing purposes or for reconstructions or for liquidations.

I wish, however, to extend the limits of my paper in one direction. I deal hereunder in some detail with the recent enactments regulating the position and responsibilities of our profession in Germany, and I also describe the probable future trend of the relative legislation in Germany. These developments have taken place since the Congress held in Amsterdam, and for that reason alone would deserve special mention by a speaker dealing with the

German matters. I also give in an appendix the full text (with unimportant abridgments) of the recent amendments to the Commercial Code of Germany. These amendments not only prescribe definite and detailed rules as to the valuation of items for balance sheet purposes, but also lay down the form of the balance sheet and the profit and loss account which must be adopted by all public companies (Aktiengesellschaften) in Germany for their published accounts. In most countries special classes of undertakings, *e.g.* railway companies, are bound to statutorily prescribed forms of accounts, and the provision of a form of accounts to be applicable to all companies or of a number of forms of accounts each applicable to one class of undertaking has often formed the subject of discussion in professional circles the whole world over. Germany has now dealt with this question by legal enactment and I am sure that the solution reached will be studied with interest.

II.

PRESENT-DAY ORGANISATION OF THE PROFESSION IN GERMANY.

Under date of September 19th, 1931, the Government then in power issued a decree to amend and reform certain parts of the company law. Partly as a result of this decree and partly as a result of other legislation which was carried through at the same time the status and functions of our profession have been fundamentally changed in Germany. It is too early yet to regard the reforms as finally consolidated; we are expecting the Government to bring out a new company law in the course of the next few months which will naturally embody the legal and economic principles which govern the political situation of Germany to-day. There is no doubt that the new company law will be based substantially on the decree of 19th September, 1931, and it is quite certain that the compulsory audit of public companies (Aktiengesellschaften) will form the central theme of this law, as it formed the central theme of the decree now governing the interim period. In responsible Government circles there has been, and there still is, the conviction that an effective reform of the law and procedure respecting companies can only be attained when the individual reforms are based on the principle that companies must be subjected to an audit comprising not only a comparison of the accounts presented with the books but also a verification of the individual items by reference to the underlying evidence.

These reforms necessitated changes amounting to an entire re-organisation of our profession. For the carrying out of these audits a qualified body of auditors, *i.e.* men uniformly qualified as regards their personal and professional qualifications, was needed. For this purpose there was created by virtue of enactments of the Reich Government and of the Governments of the various States concerned a special profession within the group of persons who had hitherto practised in Germany as accountants or trustees of various kinds, called "Publicly Appointed Approved Auditors" (Wirtschaftsprüfer).

The remarks which now follow give, of course, only an outline of the position; considerations of space compel me to confine myself to matters of importance only: The "approved auditor," in accordance with his official designation, "publicly appointed approved auditor," is an expert who before being admitted has taken an oath and who, as a member of a liberal profession, undertakes audits, in particular the audits compulsorily prescribed by law. He must make his profession his main activity and he is prohibited from engaging in commercial pursuits. His appointment is made by the Governments of the States, and the authority for the appointment is contained in an agreement concluded between the Reich Government and the State Governments, regulating the matter uniformly for all States. The appointment, however, is valid for the whole of Germany.

"Approved auditing companies" are public limited companies (Aktiengesellschaften) and private limited companies (Gesellschaften mit beschränkter Haftung, or for short, G.m.b.H.) and other associations of individuals, in particular partnerships, which devote themselves exclusively to the work carried out by approved auditors. A special procedure has been set up in order to ensure that the persons directing these companies shall have the capacities, personal and professional, required of individual approved auditors; and thereupon, after being entered in a register kept by the Board for publicly appointed approved auditors, they are admitted to practice as auditors. Branch offices which are carried on as independent units may only carry out compulsory audits if the local manager or partner in question is himself an approved auditor.

The conditions of admission offer a guarantee that only persons having suitable personal and professional qualificatons are selected.

The applicant must—

(1) Be of acknowledged financial probity;
(2) Be regarded as being particularly suited to the profession by reason of his personal character;
(3) Be at least 30 years of age;
(4) Have had practical experience of business for at least six years, of which at least three years must have been spent in auditing;
(5) Pass an examination dealing with all matters of practical importance to an auditor.

The primary functions of approved auditors and auditing companies are:—

(1) The compulsory audit of public companies.
(2) The audit of commercial undertakings of public bodies which are subject to compulsory audits.
(3) The compulsory audit of insurance undertakings and building societies.

Furthermore the activities of auditors cover:—

(4) The audit of the accounts of all other classes of undertakings and special accounting work in connection with profit estimates and financing schemes.

(5) The preparation of accounts and reporting thereon, preparation of opinions in connection with the computation of profit-earning capacity of a company and with the valuation of plant.

Publicly appointed approved auditors may also by virtue of the rules and regulations applying to the profession undertake the following classes of work apart from pure auditing :—

(6) Advice on " business economics," organisation of accounts and system work.

(7) Advice in connection with financial and credit matters, the preparation of opinions on borrowing capacity.

(8) Advice on the formation, merger and reconstruction of companies and on liquidation problems in connection with bankruptcy and deeds of settlement.

(9) Advice and representation in tax matters.

(10) Trustee work, *i.e.* as trustee either in voluntary or compulsory compositions, in testamentary matters, in bankruptcy matters, in administration of estates or as trustee in the narrow sense of the word, *e.g.* as holder on behalf of the pledgor, &c.

The Board for publicly appointed approved auditors consists of persons drawn from the profession itself and from representative business organisations together with nominees of the Government of the Reich, of the Governments of the States and of associations representing the interests of municipalities, and certain representatives from the universities. It has the power to lay down rules having the force of law regarding the conduct of approved auditors in professional matters. The oath taken by approved auditors binds them not only to secrecy but also to carry out their duties " without fear or favour."

The approved auditors are subject to the supervision of the Chamber of Commerce where they are situated. A procedure has been designed to enable the appointment of an approved auditor to be withdrawn. The recognised professional body which looks after the professional interest of publicly appointed approved auditors is the " Institut der Wirtschaftsprüfer " (Institute of Approved Auditors) in Berlin. Admission and examining boards are situated in 13 towns in Germany, viz :—Berlin, Bremen, Breslau, Frankfurt, Hamburg, Cologne, Königsberg, Leipzig, Mannheim, Munich, Münster, Nürnberg and Stuttgart, and correspondingly the Institute has sub-committees in each of these towns which watch over the professional conduct of its members and arrange for lectures, &c., on subjects of interest to the profession. Attached to the Institute is a court of honour, which deals with cases of breaches of professional etiquette and ethics.

III.

STATUTORY FUNCTIONS OF APPROVED AUDITORS IN GERMANY.

The main function of approved auditors, individuals as well as auditing companies, is the compulsory audit of public companies. In sect. 262 (*a*) of the Decree of September 19th, 1931, it is laid down that the annual accounts of a public company, as reflected by the books of the company and as amplified by the report of the management, are to be audited by one or more expert auditors before they are submitted to the general meeting for approval. Only approved auditors may be appointed " auditors " for this purpose. They are elected by the general meeting of the shareholders (sect. 262 (*b*)), and the election should take place before the end of the financial year, failing which the local court is empowered to " appoint " an auditor. The management is bound by statute to issue to the auditor elected by the shareholders instructions to carry out the audit. Sect. 262 (*c*) lays down that persons over whom the company to be audited is in a position to exercise a material influence, may not be either elected or appointed auditors. Furthermore, neither members of the management nor of the board of supervision nor employees of the company may be elected or appointed auditors.

In sect. 262 (*d*) it is laid down that the management must allow the auditors to inspect the books and documents of the company and must allow them to ascertain by physical inspection the amount of cash and investments and goods held by the company. The auditors can demand from the management all explanations and evidence which a careful fulfilment of their duty to carry out an audit necessitates.

Sect. 262 (*e*) lays down that the auditors must make a written report on the result of their audit. In this report it must be particularly stated whether the system of book-keeping, the annual accounts and the report of the management comply with the law, and whether the management has supplied the explanations and evidence demanded. The report is to be laid before the supervisory board. Each member of the supervisory board is entitled to see the report. The supervisory board in its comments on the report of the management must give the name of the approved auditor who carried out the audit and must include a statement commenting on the report of the auditor. Furthermore, information must be given in the general meeting which resolves upon the annual accounts as to whether the general findings of the audit gave rise to criticisms of a material nature or not.

Sect. 262 (*f*) deals with the certificate. If the result of the audit has been to confirm that there are no material objections to raise to the accounts as presented the auditors must state this in the form of a certificate to the accounts, in which the following must be stated :—

> Whether after a conscientious audit based on the books and decuments of the company and on the explanations and evidence supplied by the management the system of bookkeeping adopted, the annual accounts and the report of the management comply with the provisions of the law.

This certificate must be included in every publication of the accounts.

With regard to the duties of the auditors it is

laid down in sect. 262 (*g*) that auditors, and, where they employ other persons on an audit, these latter persons, are bound to conscientious and impartial auditing and to secrecy. They are prohibited from making use in an improper manner of commercial and technical secrets which they have learned in the course of their duties. Persons who contravene this obligation are liable to the company for any damages arising therefrom. The liability, however, is limited for each audit to R.M. 100,000 in cases where merely negligence can be proved, even when several persons were engaged on the audit or several actions giving rise to a claim for damages have taken place.

IV.

THE AUDITOR'S RESPONSIBILITY.

Sects. 262 (*f*), dealing with the certificate, and 262 (*g*), which define the principles for fixing the responsibility which an auditor has to accept for his work, are, of course, the most interesting sections to us in connection with the subject of my paper.

(*a*) *In relation to his certificate.* These legal provisions are intended to provide only the foundation of the building as it were; the rules laid down are restricted therefore to a generalised statement of principles. This remark applies particularly to the certificate. In the earlier papers on this subject the wording of the certificate always played a large part. I regard it as dangerous to give too much weight to the wording. Our responsibility in auditing annual accounts is not a mere matter of form. Neither the wording of the law nor the wording of the certificate can be finally decisive in the matter. The essential point in connection with responsibility is the purpose of the audit and of the certificate. We should only regard the wording of the certificate as something which helps to express in words the purpose lying behind the introduction of compulsory audits as the main aim of the company law reform. Any such means that only helps to express something else must be imperfect. There is surely no one among us who would support without reserve the statement that any wording of certificates, which is to-day common, can express everything that there is to say. The wording of the certificate is a secondary matter. The fact that in discussing our responsibilities this matter has been pushed so much into the foreground, has often unfortunately given persons who are not well versed in these matters, the impression that our audit is either exclusively or at any rate predominantly a matter of pure formality.

Admittedly—and I make this remark in order to avoid misunderstanding—the importance of the statutory wording of the certificate should not be underestimated. I know that in individual cases in practice it certainly has a very considerable importance. If we, however, wish to define our responsibility in a code of principles, we cannot cite the wording of the certificate as decisive, but rather that which lies behind this wording and should be expressed by it, that is to say, the purpose of the audit.

What does the German Decree of September 19th, 1931, say in this matter? The provisions regarding the scope of the audit, the report and the certificate show clearly the goal which is aimed at. The auditor, as a person charged with the duty of assisting the supervisory board, must see to it that the management of the company has issued true accounts.

(*b*) *As compared with that of the management.* According to German company law the auditor occupies an auxiliary position only. In the first place, the management (having regard to its duty to carry on the business of the company) and the supervisory board (in view of its duty to supervise the company generally) bear the responsibility for the preparation of the accounts. The responsibility of the auditor is secondary to this. He is only responsible for the audit itself and not for the company and books to be audited. The auditor has not the same kind of responsibility for the annual accounts as the management; on the one hand, his responsibility is greater and on the other hand it is smaller than that of the management.

It is greater in two matters. Firstly, the auditor, being a professional approved auditor, is an expert in accounting matters. Theoretical knowledge and practical experience in the relative accounting and legal fields of knowledge exceeding those expected generally of the management are required of him. He must do his work with the carefulness of a professional expert, and as a consequence he bears more responsibility than the non-expert, *e.g.* a member of the management. In another matter, too, the responsibility of the auditor for the annual accounts exceeds that of the management. In preparing accounts the management must and can in general rely on the material produced by its bookkeeping department, and this all the more seeing that it is to be examined by the auditor. The auditor, however, in view of his duty to audit, must take responsibility for the regularity of the material upon which he works.

On the other hand, the responsibility of the latter may also be less than that of the management in certain cases. He is outside the undertaking and the conduct of its business. He cannot, therefore, know whether items which should have been booked have actually been taken up in the books. The auditor can also not accept an absolute warranty for the completeness of the annual accounts and of the material on which they are based. An auditor certainly must make use of his critical faculties in this direction, and in many cases by the exercise of care and of his expert knowledge he will be able to ascertain that the material on which the annual accounts are based is not complete and that all items have not been booked. But cases can easily arise in which the fact that material was missing could not have been ascertained by the auditor; on the other hand, of course, the management in such cases would be open at least to the charge of culpable negligence and possibly of criminal conduct.

From the fact that the auditor is auxiliary to the supervisory board arises a further limitation of his responsibility for the annual accounts. He is naturally only responsible for the annual accounts which

he has audited and certified, and it is immaterial to him what set of accounts is laid before the general meeting by the management and approved in general meeting. The work of the auditor ends with the issue of his certificate and with the report to the supervisory board. What the latter does with these documents is their business. They are responsible for them, not the auditor.

(*c*) *For the correctness of the accounts.* Having thus far dealt with the principles regarding the responsibility which the auditor bears arising out of his position as auxiliary to the supervisory board, we now turn to the deductions which are to be drawn from the fact that the auditor is responsible that the management adopts the principles of proper accounting.

Accounting is "proper" if it complies with the law and with such commercial practices as are in Germany within the law. The report of the management and the annual accounts (including the bookkeeping) must comply with the provisions of the law and with the general principles of correct bookkeeping and preparation of balance sheets. German company law contains very detailed provisions in this regard, in particular for the annual accounts. The principles are given in sect. 260 (*b*), sub-sect. 2, which reads as follows :—

> "The annual accounts are to be drawn up so clearly and perspicuously that they provide the parties interested with as sure a view of the position of the company as possible."

In sect. 261 (see appendix) will be found the provisions regarding the valuation of important assets and liabilities. In sect. 261 (*a*) (see appendix) the classification of the balance sheet and in sect. 261 (*c*) (see appendix) the classification of the profit and loss account is laid down.

In German law, therefore, we have very detailed provisions aiming at balance sheet truth and balance sheet clarity. But neither the Government nor professional circles were ever in doubt that the power of the law is restricted to setting up standards only, that legal provisions cannot be devised which will secure an absolutely "correct" balance sheet. This is so for the folowing reasons :—

(1) From their nature annual accounts must be incomplete. The transactions of a going concern, which in their totality commence with the formation of the undertaking and end with its liquidation, cannot be absolutely correctly expressed on any particular date in marks and pfennigs.

(2) The undertaking is an economic whole ; it is only possible to give some sort of expression to its real value by resolving the individual transactions or the existing legal and economic rights and duties of the company into individual asset and individual liability items in the accounts, and showing its value as the sum of these assets less the liabilities.

(3) There are important economic factors—for the financial positon of the undertaking often the most important—which are not expressible in the accounting of the undertaking at all.

(4) The law consists of regulations covering the general case. In the individual case very often matters peculiar to the special case in question (for instance, the class of trade, the size of the undertaking, the relationship to other concerns) are of decisive importance, and account must be taken of such exceptions to the general rule, if the accounts are to be clear and true.

There can, therefore, be no absolutely correct annual accounts and there are good reasons for the fact that even experts, basing themselves on a similar set of facts, can come to entirely different annual accounts and that each expert could perfectly justifiably describe his annual accounts as clear and true.

Recognising this, the law has not gone further than to lay down the goal that is to be aimed at (sect. 262 (*b*)) :—The annual accounts must be clear and true. The law has indeed in a few matters set up rigid rules of valuation, but for the rest it has confined itself to laying down rules covering the general case. It has allowed the necessary latitude to conscientious opinion in preparing annual accounts within the limits of these rules.

This applies in particular to the persons responsible for the preparation of the annual accounts, but it also applies from the nature of the case to the auditor. He can only object to the annual accounts when the management has not kept within the permissible degree of latitude ; but then he is compelled to register his objections.

We can never under any circumstances undertake to warrant that the annual accounts are absolutely correct, but only that they comply with the provisions of the law. This finds clear and unambiguous expression in the form of certificate as it is prescribed in German company law. This certificate confirms that the requirements of the law have been satisfied. It does not certify, for instance, that the annual accounts show absolutely correctly the assets or the profit or the loss. Every one of us will probably think of the delicate subject of secret reserves. If secret reserves exist, the balance sheet in general does not show the real financial position of the company, and consequently an auditor cannot give a certificate that the accounts are absolutely correct. But he can confirm that it complies with the requirements of the law, since secret reserves are in principle allowed by the law.

Although the law allows a certain latitude to the judgment of the persons preparing the annual accounts, it does not thereby, of course, open the door wide to arbitrary conduct. This rule applies in the first place to the management in the preparation of the annual accounts. The management has not an entirely free hand, but is bound by the general rules of conduct applicable to business men. This rule applies still more to the auditor. Not the least important of the functions with which he has been

endowed by law is the duty of determining where latitude of judgment ends and arbitrary conduct begins. The auditor is not an executive of the company, he is not part of the management, he is responsible to the company as an entity and he stands outside any conflict of interests between the management and the shareholders. He can and must see to it that the annual accounts, within the latitude allowed by the law, are prepared as accurately as possible. This finds also expression in the law. Our certificate begins with the words "After a conscientious audit." It is well known that in the discussions which preceded the framing of the Decree this expression was inserted to make clear on the one hand that the auditor cannot guarantee an absolute correctness of the accounts, seeing that his findings are naturally based on his own judgment, and on the other hand that the audit has been carried out, following the words of sect. 262 (*g*), "carefully and impartially" as is shown by the employment of the word "conscientious." Thus we accept with our certificate the responsibility for the real correctness of the annual accounts, without, of course, excluding in any way the necessary latitude of judgment.

(*d*) *In relation to the interests of the company and of the State.* This duty of ensuring that the accounts are as "fair" as possible does not stand alone, however, without relation to other factors as if it were in a vacuum. It definitely depends on certain factors. The auditor must not, of course, let himself be influenced by the private interests of the management or of the supervisory board or of a shareholder or group of shareholders, not to mention by his own private interests. What must govern his conduct are interests which reach further, namely, those of the company and of the general public. That the interests of the company have very great weight, always of course within the limits of the law, is obvious from the fact that he is responsible to the company for his work. He is liable to the company directly for damages which he causes by improperly carrying out his duties (sect. 262 (*g*)). Moreover, the interests of the company are expressly mentioned in the law. In one important case the interests of the company are regarded as taking precedence over the legal regulations. In sect. 260, sub-sect. 4, it is laid down that information that ought otherwise to appear in the annual report can be omitted if the overriding interest of the company demands it.

In this section mention is also made of the overriding interest of the public. This also takes precedence over the compulsion to give information and must be observed not only by the management but also by the auditor. As I have said, this section only applies to the report, not to the annual accounts, and its position with the law indicates that it is only to be taken as a hint. But I regard it as very probable that the coming Company Law will place the interests of the company, and above all those of the State, very much more strongly in the foreground, and will make these interests the deciding factor in the question whether the annual accounts comply with the legal requirements for the purpose of giving the certificate.

(*e*) *Summary.* I should like to summarise the principles I have enunciated as follows :—

(1) The determining factor in the question of responsibility is the purpose of the audit and of the certificate.

(2) As auxiliary of the supervisory board, the auditor must satisfy himself that the management keeps and has presented proper accounts.

(3) The auditor bears partly a larger, partly a smaller responsibility for the annual accounts than the management.

(4) He cannot guarantee the absolute correctness of the annual accounts.

(5) In passing on the annual accounts which are prepared the auditor must be allowed a certain latitude of judgment.

(6) The auditor cannot accept an absolute guarantee that material (books, letters and other sources of information) has not been suppressed and that, therefore, the annual accounts are not defective.

(7) But he is responsible that the annual accounts comply with legal requirements.

(8) He has to guarantee that the annual accounts are really correct, that is to say, that within the latitude allowed by the law, they are as correct as they possibly can be.

V.

CONCLUSIONS.

The principles that I have enunciated show the extent to which the limits of our responsibility, upwards and downwards, are determined. I should like in this connection to emphasise one point which is really self-evident, but must always be brought out strongly, viz: that the very purpose of the audit and of the certificate make it clear that the audit required is not merely a formal one, *i.e.* that the figures in the ledger correspond with the figures in the annual accounts, but that it must be an audit of the books and underlying documents. The Decree mentions this specifically in sect. 262 (*a*), sub-sect. 2.

It is difficult to define comprehensively in a few words the limits of such an audit. In my view one can only say that the principle by which an approved auditor must be guided is that he has got to pursue his investigations until he can conscientiously satisfy himself that, exercising all his skill and after most careful consideration, he can give a certificate for the annual accounts. The degree of skill required in our case is a special one: it is the degree of skill required of the professional expert and it exceeds the degree of skill demanded of the ordinary business man. It is expected of an auditor that he should display that amount of practical and theoretical knowledge and of experience in his work that a member of our profession in view of the developments in accounting must to-day have. This principle applies more particularly to answering one of the

most doubtful points, but nevertheless one of the most important points in our subject.

In nearly all the usual certificates and also in the German form of certificate we find mention made of the books and documents, *i.e.* the material on which the preparation of the annual accounts is based. This common restriction of the certificate is specially designed to bring out, as I have already mentioned, that an absolute guarantee for the completeness of the books in particular cannot be accepted. Even where the auditor has exercised the highest degree of skill it will be impossible for him in many cases to ascertain whether all transactions which should have been booked have actually been booked. In such cases he must exercise the professional skill of the expert auditor who must form for himself a clear view on the matter by the employment of his critical faculties upon the material supplied.

Finally, I should like to answer the question shortly, to whom is the auditor responsible?

I have already stated that according to Company Law he is directly responsible to the company and particularly for the damages which the company suffers because he has neglected his duties. This liability is unlimited in the case of intentional wrong-doing, and is limited where the wrong-doing is negligent to R.M. 100,000 for each audit. As far as Company Law is concerned, therefore, the auditor is only liable to the company, not, however, to its executives and not to third parties, such as, for instance, creditors or shareholders. Of course, in certain cases the question of criminal liability to third parties might arise under the general principles of common law.

In professional circles, however, we are all conscious that the moral responsibility goes far beyond this purely legal responsibility and that we are responsible not only to the company but also to its executives, to the shareholders, to creditors and to the public. We owe this sense of moral responsibility as a duty to our profession which can only attain a standing corresponding to the tasks laid on it when it is dominated by a consciousness of responsibility that is not merely defined and limited by legal regulations.

I have several times emphasised that our responsibility is not least of all determined by the interests of the public. I have pointed out that in the present Decree hints in this direction exist and that the coming law in Germany will probably lay down definite rules in this connection. There is no doubt that in the National and Social State our profession must fit its activities into the common weal and carry out its task to the benefit of this State.

APPENDIX.

EXTRACTS FROM THE GERMAN COMMERCIAL CODE

SECTION 260.

(1) The general meeting shall resolve on the annual balance sheet and profit and loss account (annual accounts), on the distribution of profit and on the discharge of the management and the supervisory board from liability for their conduct of the business.

(2) The management must submit the annual accounts and a report to the supervisory board and must present these documents together with the comments of the supervisory board on the report of the management to the general meeting in the first three months of a financial year for the immediately preceding financial year. The statutes may provide for a longer period than three months, but the period shall not exceed six months.

SECTION 261.

The following rules apply to the valuation of the individual items in the annual balance sheet:—

(1) Fixed assets and other assets which are intended to be used permanently in the business of the company may be stated at the cost of acquisition or at the cost of production without regard to the fact that they have a smaller intrinsic worth, provided that the proportion of loss of value corresponding to the ratio between the period covered by the annual accounts and the period of probable useful life of the asset in question, is deducted from the figure at which the asset stands in the balance sheet or is carried in a depreciation account. In computing the cost of production a reasonable amount of depreciation and a reasonable proportion of the factory and administrative costs, corresponding to the time required for the production, may be added; selling costs, however, may not be treated as factory or administrative costs for this purpose.

Investments which are intended to form a permanent part of the company's property, may be stated at the cost of acquisition without regard to the fact that they have a smaller intrinsic worth, provided that the general principles of honest accounting would not necessitate their being written down.

(2) Investments and other assets which are not intended to be retained as such as part of the company's property permanently, including goods for sale and own shares held by the company may be stated either at the cost of acquisition or at the cost of production. In computing the cost of production regard may be had to the second sentence of the first sub-section of 1.

If the cost of acquisition or of production of an asset exceeds the market (or stock exchange) value on the date of the balance sheet, the asset may not be stated at a figure in excess of this latter value.

If, in cases where a market value is not ascertainable, the cost of acquisition or of production of an asset exceeds the value that may be placed on it, the asset may not be stated at a figure in excess of this latter value.

(3) The expenses of the formation of the company and of increasing its capital may not be shown as assets.

(4) An asset may not be shown representing the goodwill attaching to the business. Where, however, the consideration given for the acquisition of an undertaking exceeded the

value of the individual assets composing the undertaking at the time it was acquired, the difference may be shown as a separate item on the assets side of the balance sheet. The asset must be amortised in yearly annual instalments which must be reasonable having regard to the circumstances of the case.

(5) Loans granted to the company must be shown under the liabilities at the amount which is repayable. If this amount exceeds the sum received when the loan was granted, the difference may be shown as a separate item on the assets side of the balance sheet. The asset must be amortised by yearly instalments which may be spread over the whole period of the loan.

(6) The amount of subscribed capital must be shown as a liability at its full nominal amount.

SECTION 261 (*a*).

(1) The following items must be shown separately in the annual balance sheet, so far as the nature of the business does not necessitate a different classification; a more detailed classification, however, is permissible :—

A.—ASSETS.

I. Unpaid and uncalled capital.

II. Fixed assets :—
- (1) Land.
- (2) Buildings—
  - (*a*) Office buildings and dwelling houses;
  - (*b*) Factory buildings and other structures.
- (3) Machinery and fixtures.
- (4) Tools, factory and office furniture and furnishings.
- (5) Concessions, patents, licences, trademarks and rights of a similar character.

III. Holdings in other companies. In case of doubt a shareholding in a company which is equal to or exceeds one-fourth part of the capital of that company is to be regarded as a holding.

IV. Current assets :—
- (1) Raw materials and operating supplies.
- (2) Processed goods.
- (3) Finished goods.
- (4) Investments and securities held, provided that they do not fall under III, IV, Nos. 5, 11 or 12.
- (5) Own shares belonging to the company (the nominal amount of these shares must be indicated).
- (6) Mortgages and land-charges held by the company.
- (7) Payments in advance effected by the company.
- (8) Debts due for deliveries of goods or services rendered.
- (9) Debts due by subsidiary companies and by companies in the same group.
- (10) Debts due by members of the management or by a member of the management of a subsidiary company or of a company of which the company whose balance sheet is presented is itself a subsidiary or by the wife or children of such a member of a management or by any third party for account of such persons.
- (11) Bills receivable.
- (12) Cheques.
- (13) Cash on hand including credit balances with banks having the right of note-issue and with the postal authorities.
- (14) Credit balances with other banks.

V. Items in suspense deferred to the following year.

LIABILITIES.

I. Subscribed capital, the total nominal amount of preference shares of each series must be shown separately; if a class (series) of shares has been issued endowed with voting rights exceeding those of other classes (series) denomination for denomination or where one class (series) of shares has voting rights in proportion to its denomination not corresponding with the voting rights attaching to the denomination of other classes (series) of shares, the total voting power of the thus preferred shares and of the non-preferred shares must be indicated.

II. Reserve funds :—
- (1) Statutory reserve funds.
- (2) Other reserve funds.

III. Reserves.

IV. Depreciation reserves.

V. Creditors.
- (1) Loans taken up by the company (if secured by a land-charge, this must be indicated).
- (2) Charges resting on the land belonging to the company, so far as they are not merely charges to secure the payment of a debt or in connection with loans taken up by the company.
- (3) Prepayments of customers.
- (4) Liabilities in respect of goods supplied or services received.
- (5) Liabilities to subsidiary companies or to companies within the same group.
- (6) Bills payable.
- (7) Liabilities to banks.

VI. Suspense items deferred to the following year.

(2) The profit or loss for the year must be shown in one figure as the last item of the balance sheet and must be segregated from the profit or loss carried forward from the previous year.

(3) In the case of fixed assets and holdings in other companies increases or decreases in respect of each balance sheet item must be shown separately. Debts due to the company may not be set off against debts

due by the company; similarly charges on land, so far as they are not legally classifiable as debts due by the company, may not be set off against the asset representing the value of the land itself. Items which are classifiable as reserve funds, reserves or depreciation reserves must not be included among the creditors of the company. If debts due to or by the company could be classified under several items, a note must be made to the item under which they are shown that they could be classified otherwise, if this is necessary in order to set forth the position clearly and perspicuously. Own shares of the company held by it may not be shown under other items.

SECTION 261 (*c*).

(1) The following items must be shown separately in the profit and loss account, so far as the nature of the business does not necessitate a different classification; a more detailed classification is, however, permissible :—

I. Expenditure :—
- (1) Salaries and wages.
- (2) Social services.
- (3) Depreciation of fixed assets.
- (4) Other amounts written off.
- (5) Interest paid (but only to the extent that it exceeds interest received).
- (6) Taxes on the property and income of the company.
- (7) All other expenditure except the cost of raw materials and operating supplies or, in the case of a merchanting business, the cost of goods purchased.

II. Income :—
- (1) The balance of income after deducting the cost of raw materials and operating supplies or, in the case of a merchanting business, the cost of goods purchased and after deducting the items which are to be shown separately under Nos. 2-5 below.
- (2) Income from holdings in subsidiaries.
- (3) Interest receivable (but only to the extent that it exceeds interest paid) and other income from investments.
- (4) Special income.
- (5) Extraordinary receipts.

(2) The profit or loss for the year must be shown in one figure as the last item of the profit and loss account and must be segregated from the profit or loss carried forward from the previous year.

This was followed by a third Paper on the same subject from

THE AMERICAN POINT OF VIEW

BY

Colonel ROBERT H. MONTGOMERY, C.P.A.

Colonel MONTGOMERY said :—

During the last few years, in the United States, the whole question of the auditor's legal responsibility has been discussed at such great length and in such detail that one might think that we have been confronted with a new problem. However, instead of it being a new problem it is as old as the profession itself. We have nothing new to report because there has been no change whatever in our legal responsibilities.

Our problem embraces four major considerations :

(1) To what extent is an auditor liable to a client for negligence.

(2) The scope of employment as affecting liability to clients.

(3) The proposition that an auditor may be liable to third parties for negligence.

(4) When gross negligence is so great as to be fraudulent and thereby create liabilities to third parties.

I.

TO WHAT EXTENT IS AN AUDITOR LIABLE TO A CLIENT FOR NEGLIGENCE.

The profession of public accounting in the United States is about 50 years old. When it started it automatically became subject to a principle of common law which had been in force in the United States for at least 100 years and much longer in Great Britain. The rule at that time and at the present time is that one who holds himself out as an auditor for hire represents that he is capable of performing such work in a skilful manner; and if he fails to do so, he is liable to his client for loss sustained by reason of his negligence. It is not a rule which can be covered by specifications. There are certain logical modifications and limitations but each case of alleged negligence differs in its facts from every other case so that what may be held to be negligence in one case may be excusable in another.

We all agree that where there is negligence, there is liability to clients. The following definition of negligence is quoted from *Railroad Company* v. *Jones* (95 U.S. 439-441) :—

> "Negligence is the failure to do what a reasonable and prudent person would ordinarily have done under the circumstances of the situation, or doing what such a person under the existing circumstances would not have done."

If in certain matters the auditor falls short of his real duty, it may be because, in all good faith, he holds a mistaken belief as to what that duty is. The auditor may conduct the audit honestly and carefully within the scope he understands it to cover. He may make an error of judgment, an error of judgment which may be the direct or proximate cause of disaster.

Usually the auditor makes tests to determine the accuracy or sufficiency of the record. Much depends on these tests.

In the *Ultramares Case* (hereinafter referred to at more length) the Court of Appeals of the State of New York (the highest court having jurisdiction) considered the work usually performed by auditors.

The following is quoted from Judge Cardozo's opinion :—

" Care should of course be taken to conduct the tests in such a way as to obtain the maximum assurance of regularity from the work done. Care should also be taken to indicate in reports and in certificates when the test-checking procedure is used, as distinguished from complete verification. A statement to this effect not only affords protection to the accountant but it enables the person who reads the report or reviews the statement to know what was done, and, therefore, to draw his own conclusions with respect to the soundness of the basis on which the accountant formulated his opinion."

If the auditor offers his services in a calling that requires peculiar skill, he is understood to possess the degree of skill that is common in that particular calling. If he fails to possess that skill he will be liable to his client for resulting damages. As was said by a New York Court, in *Smith* v. *London Assurance Corporation* (109 App. Div. (N.Y.) 889 (1905)) :—

" The plaintiffs do not challenge the proposition of law advanced by the defendant that public accountants now constitute a skilled professional class and are subject generally to the same rules of liability for negligence in the practice of their profession as are members of other skilled professions, and such is doubtless the law."

II.

The Scope of Employment as Affecting Liability to Clients.

In determining whether or not an auditor has been guilty of negligence, it is necessary to consider specifically what he was employed to do. A client cannot expect a detailed audit where the auditor was engaged to make merely a balance-sheet audit. The auditor should be careful, however, to obtain definite written instructions to which he can refer and to limit his statements and certificates to the matters of which he has actual knowledge.

Sometimes after a balance-sheet audit, specifically requested in writing, has been made and the report rendered, it is discovered that petty defalcations have been going on for a long time. It is natural for the client, in such a case, to criticise the auditor, but if the latter has specific instructions to which he can refer, he can clearly show that the detection of the small theft was not within the scope of the audit.

The scope of the employment cannot be determined simply from the compensation paid, though in a doubtful case the amount of compensation would be some evidence of the character of the employment. An auditor may undertake to perform for 100 dollars work for which the reasonable compensation is 1,000 dollars. He will nevertheless be held to have agreed to exercise the skill of his calling in the work which he agreed to do.

In some cases, clients may be shown to have caused the damage in question by their own carelessness. If the proximate cause of the loss was the negligence of the client's own officers or employees, the auditor should be freed from liability, following the accepted principles of law.

Damages to Clients for Negligence.

The damages, to which a client is entitled by reason of the auditor negligently performing his contract, will depend largely upon the facts of the particular case. There is no doubt that if the auditor negligently performs his duty the client is entitled to recover back whatever fees he has paid the auditor. Whether or not the consequential damage arising out of the auditor's neglect, should also be included as an item in the client's recovery, is a more difficult question. Many courts feel that it is not sufficient that the auditor's neglect was the proximate cause of the client's loss, but it is also necessary for the client to prove that it was reasonably foreseeable that neglect would cause such a loss before a recovery for consequential damages can be had. This view is well expressed in a decision from the highest court of one of our western states in *City of East Grand Forks* v. *Steele*, 121 Minn. 296, 45 L.R.A. (N.S.) 205 (1913).

This was an action to recover (first) the fees paid the auditor by the client, and (second) damages arising from the negligence of the auditor. The subject of privity of contract was, therefore, not in question, because the employment was direct. The city was allowed to recover back the amount paid by it to the defendant for the services which were held to have been performed negligently in that they failed to discover embezzlements which had been occurring prior to and continued to occur subsequent to the audit. The demand for damages, however, was denied. Chief Justice Taylor remarked :—

" Defendants represented themselves as expert accountants, which implied that they were skilled in that class of work. In accepting employment as expert accountants, they undertook, and the plaintiff had the right to expect, that in the performance of their duties they would exercise the average ability and skill of those engaged in that branch of skilled labour. They were employed to ascertain, among other things, whether any irregularities had occurred in the financial transactions of the city clerk, and, if so, the nature and extent of such irregularities. If, from want of proper skill, or from negligence, they did not disclose the true situation, they failed to perform the duty which they had assumed, and failed to earn the compensation which plaintiff had agreed to pay them for the proper performance of such duty.

" The work of an expert accountant is of such technical character and requires such peculiar skill that the ordinary person cannot be expected to know whether he performs his duties properly or otherwise, but must rely upon his report as to the thoroughness and accuracy of his work. The full contract price having been paid in the belief, induced by defendant's report, that such

report disclosed fully and accurately the condition of the city's accounts, the city is entitled to recover back the amounts so paid, upon proving that, through the incompetence or the negligence of defendants, the report was in substance misleading and false.

". . . The damages claimed on account of the losses resulting from the defalcations of the clerk and the insolvency of his surety are too remote to be recovered, without showing the existence of special circumstances, known to defendants, from which they ought to have known that such losses were likely to result from a failure to disclose the true condition of affairs. Such losses are neither the natural nor the proximate consequences of the failure of defendants to make a proper audit. Neither are any facts shown from which it may be inferred that a loss from either of these causes was or ought to have been contemplated, when the contract was made, as likely to result from a breach of duty on the part of defendants.

"If at the making of the contract and in the light of the knowledge then possessed by them, the parties had taken thought as to what consequences might reasonably be expected to result from its breach, there is nothing set forth in the complaint from which we can say that they ought to have foreseen or to have contemplated that the clerk was likely to commit a crime, or that his surety was likely to become bankrupt, and thereby entail financial loss upon the city. There may be circumstances under which the negligence of an expert accountant may make him liable for losses, as where he is employed to determine the amount that should be exacted from a surety for the default of his principal; but the facts alleged in the complaint do not bring this case within any such rule."

III.

The Proposition that an Auditor May be Liable to Third Parties for Negligence.

It is a dangerous and far-reaching doctrine that an auditor or any professional man may be held responsible in damages for honest blunders to one who has not employed him, when there has been no privity of contract or direct relationship. If such an extension of responsibility should be made it would so expand the entire field of liability for negligence as to make it nearly, if not quite, coextensive with that of liability for fraud. A change so revolutionary, if expedient, and if justified by current demands for higher standards of speech and conduct, must be wrought by legislation.

Auditors are not insurers. This is obvious and I shall not discuss it.

No American case has been found holding an auditor liable for damages for negligently performing his services where there was no privity of contract or duty. In other words, to date we find no authority for allowing a third party to whom a financial statement has been shown to rely (contractually) upon the auditor's certificate. There must be either privity of contract or some relationship akin to that of contract.

What some believe to be an important departure from the rule is that announced by a court in the United States in which it was intimated that negligence may be so gross that automatically a doubt arises regarding the *bona fides* of the auditor's certificate. The case in question is the *Ultramares Case*, 255 N.Y. 88, 174 N.E. 441 (1931). This was an action in tort for damages suffered through misrepresentations made by defendants. There were two causes of action: one for negligent misrepresentations and one for fraudulent misrepresentations.

One Stern & Co. employed the defendants, public accountants, to audit its books and to prepare a balance sheet. The defendants certified the balance sheet, presumably knowing that the statement was to be used by Stern to represent its financial condition in order to secure loans. There was, however, no specific mention of the plaintiffs, by name or other description. The balance sheet was negligently prepared, showing the firm to be financially sound when in fact it was insolvent. The books of the company had been falsified to set forth fictitious accounts receivable, and these fictitious accounts had not been discovered; or when discovered the explanations given the auditors by their client relative thereto were false; and, as well, various accounts receivable had been pledged simultaneously at three or four different banks, which fact was not mentioned if discovered. In short, the balance sheet did not present a correct and true picture of Stern & Co.'s condition. Plaintiffs claimed to have extended credit on the strength of the statement certified by the defendants with resulting loss. The trial judge dismissed the cause of action for fraud and granted the defendants' motion to dismiss the action for negligence after the jury had returned a verdict for the plaintiffs. In other words the jury found the defendants guilty of negligence and responsible in damages to the plaintiffs who were third parties, but the trial judge dismissed the action on the ground that the defendants could not be held responsible to such third parties in damages for negligence.

The Appellate Division (an appellate tribunal intermediate the trial court and the highest court of the State) affirmed the trial judge's decision as to the cause of action for fraud and reversed the decision as to the cause of action for negligence, relying principally on the case of *Glanzer* v. *Shepard*, 233 N.Y. 236, 135 N.E. 275 (1922), a case involving a certificate of a public weigher rather than an auditor. In other words, holding as the jury did—that the defendants were guilty of negligence and responsible in damages to the plaintiffs (third parties).

The Court of Appeals (the highest court of the State) reversed the Appellate Division on both causes of action, holding that the defendants owed not only to the employer but to prospective creditors and investors a duty to make their report without fraud, since the circumstances showed that the balance sheet and auditor's certificate would be

exhibited to such persons, but stating that there was no liability to creditors or investors (where no privity of contract existed) merely for negligence.

In rendering the opinion of the Court of Appeals, Chief Judge Cardozo stated: "The defendants owed to their employer a duty imposed by law to make their certificate without fraud, and a duty growing out of contract to make it with the care and caution proper to their calling." The Court further pointed out that if a duty to avoid being negligent with respect to creditors or investors were to be imposed, a thoughtless slip or blunder might expose accountants to a liability in an indeterminate amount, for an indeterminate time, to an indeterminate class. The Court thought that this was too great a responsibility to impose upon the business of public accountancy; that the earlier decisions did not establish such a liability; and that creating such a duty would be too violent a legislative innovation for a Court to make. In awarding a new trial to plaintiff on the fraud action, the Court held that by the nature of their calling, public accountants profess to speak with knowledge in certifying a balance sheet, and that in this case a jury could well have found that the defendants had misrepresented their knowledge. The case, therefore, was sent back for a new trial on the fraud issue to determine whether the statement of opinion in the certificate that the balance sheet presented a correct view of the financial condition of Stern & Co. had been based on such flimsy grounds and such an absence of actual knowledge as to constitute fraud. The case was not retried, having been settled out of Court.

The truth of the matter is that the service of the auditor chiefly consists of rendering an opinion. The opinion is based upon investigation and analysis, nevertheless it is still an opinion. If persons not directly concerned in the arrangement made by the auditor and his client suffer loss because they depended upon the opinion of the auditor, it is unfortunate for them. Nevertheless the fact remains that they are third parties. We cannot ignore the practical element which is that if auditors are to be responsible to the world, they will have to increase their fees, since fees depend in part on risks assumed.

The opinion of an auditor, however, as expressed in his certificate or otherwise does not expose him to liability beyond that growing out of his direct relationship to his client unless he has no genuine belief in his own statement or there has been such reckless misstatement or insincere profession of an opinion as to bring his act within the category of fraud. In other words, if he does his work and expresses his opinion honestly he will not be held responsible to third parties for mere blunders or mistakes of judgment.

Honest error is not always avoidable in human affairs, but under a logical interpretation of the decision of the lower court in the *Ultramares Case*, honest error would have made all the world forever a potential creditor of the practitioner of any profession. In that case, the auditor contended that where there is no privity of contract there can be no liability for negligence of the practitioner or his staff. In the highest court this contention prevailed. He is liable to his client and under certain very restrictive circumstances to one for whom he knows his work is intended. Except in case of fraud, he is not liable to strangers. Responsibility of auditors must be the same as that of other professional men. Auditors should not be exposed to liability to third parties "in an indeterminate amount, for an indeterminate time as to an indeterminate class."

The foregoing is somewhat mercenary and represents an attitude of which we cannot be proud. But the cold fact stares us in the face that if auditors are to be liable to all persons into whose hands a copy of the documents delivered to clients may come, the financial responsibility incurred would be beyond the means of any firm of auditors to meet. The professional opinion of auditors should not carry any such obligation.

Let us examine what constitutes privity of contract. How much knowledge is necessary on the part of an auditor to make him liable to a third, non-contracting, person? Suppose a prospective or actual client comes to an auditor and says that he wants financial statements to show to 20 banks for the purpose of floating loans; would such a state of facts give rise to a direct or contractual relationship with each of the 20 banks? At the present time—no. If there is a change it may come from the conduct of auditors themselves. Taking auditors at their word when they claim to be of value to credit grantors, any considerable number of cases of losses to third parties, because of negligence in the making of statements or giving of certificates upon which such third parties rely, might lead to a modification of the present limitation on the liability to third parties.

The *Ultramares Case* aroused great interest in the United States, particularly among the younger generation of auditors and lawyers. The following is a clearly stated criticism of the Court of Appeals of the State of New York for failing to hold the defendants in the *Ultramares Case* liable on the cause of action for negligence. This appeared in a note in 19 *California Law Review* 454 (1930) at page 456:

> "The defendants' business was of a semi-public character and they knew that investors and creditors would rely on their certificates. A duty of ordinary care would not seem to be too great an extension of liability, for the jury would consider the severity of the penalty in arriving at its verdict. An accountant in making an audit owes a moral duty not merely to the client who retains him, but to all those whom he contemplates as invited to act on the faith of his certificate. This report was made for the purpose of giving information for influencing moneylenders and investors. Should not the moral duty to furnish correct information be recognised as a legal duty? Should the responsibility extend only to those extreme defaults that can be classed as fraud, or should there not also be responsibility

for those less serious defaults classed as negligence? The court in the principal case (*Ultramares*) decided against the broader liability by more or less arbitrary limitation of the doctrine of *Glanzer* v. *Shepard* . . . "

The following is another comment on the *Ultramares Case* which appeared in 16 *Cornell Law Quarterly* 419, at pages 425, 426 (1930):—

"The decision in the principal case seems to limit liability for negligent verbal representations to three classes of cases:—

"(1) Where there is such a privity of contract between the plaintiff and the defendant that the former is led to believe that he is one of those persons specifically invited to rely upon the representation of the defendant.

"(2) Where the representation is made by a person engaged in a public calling (liability here having been imposed thus far only upon notaries).

"(3) Where the representation is made in reference to an article inherently or imminently dangerous to life or limb.

"The Court in the principal case was faced with the question of whether the rule imposing liability for negligent misrepresentations had reached its ultimate limit of social usefulness. On the one hand, there was the benefit to society from holding public accountants liable for negligent errors; on the other, was the possibility that the imposition of such an extensive and indeterminate burden might limit the activities of accountants and thereby deprive society of a substantial part of their services. The Court seems to feel that the latter consideration is the more important and, therefore, placed a definite limit on the development of the rule imposing liability for negligence. . . .

"It is true that to extend the liability of the defendants in the principal case to a 'multitude of possible investors' might well be socially undesirable at the present time. It would seem, then, that although the decision on this point in the instant case follows logically from the interpretation placed upon *Glanzer* v. *Shepard* . . . yet had the court so desired it could have reached the opposite decision by placing a slightly more liberal, and apparently logical interpretation upon the previous cases. The real basis for the decision seems to be that the court believed that the rule imposing liability for negligent misrepresentations had reached its ultimate limit of social usefulness."

I am not unmindful that frequently the auditor, before undertaking his work, is on notice (in many cases direct notice from credit grantors) that copies of his report and findings will be furnished to and relied upon by credit grantors. Can he say that he does not want his work to be relied upon or can he say that if relied upon and the credit grantor suffers a loss he will claim immunity from money responsibility on the ground that he had no direct relationship with the credit grantor? Nine times out of ten, an auditor knows the precise purpose of the audit. In ten cases out of ten, if he does not know, he inquires—for it assists him in the form, the preparation, and the amount of details that he incorporates in his report. It should definitely be understood that, when credit grantors are instrumental in bringing borrowers and auditors together, the credit grantor has a high degree of protection in that the auditor's moral responsibility and professional standing are at stake, and that if the auditor is guilty of negligence the loss of prestige constitutes heavy punishment, which should satisfy the credit grantor. I repeat that the auditor is not an insurer.

To hold the auditor responsible to third parties in money damages is too extreme a doctrine under present conditions.

IV.

When Gross Negligence is so Great as to be Fraudulent and thereby Create Liabilities to Third Parties.

The legal responsibility of an auditor to persons other than the parties to his contract of employment necessarily rests not upon contract principles but upon principles of tort law.

As has been heretofore stated, negligence does not, of itself, render an auditor liable to third parties. Negligence may be so gross, however, as to constitute evidence of fraud or to be itself fraudulent.

With respect to an action based upon fraud, certain essential elements are required. There must be a false representation of a material fact, which was known to be false by the party making it, or else recklessly made; the misrepresentation must be made with intent to deceive and for the purpose of inducing the other party to act upon it; the other party must in fact have relied on it to his injury or damage: *Farrar* v. *Churchill*, 135 U.S. 609.

The broadest classification of fraud, and one which is essential to a complete understanding of an auditor's liability arising out of his verification, is actual fraud and constructive fraud. To constitute actual fraud there must be an intentional deception. Such cases do not furnish a very grave problem to an auditor. Constructive fraud covers the cases where a wilfully false representation is presumed from the circumstances of the transactions and the situation of the parties, and where a fraudulent intent may be imputed or inferred on the theory that one must be presumed to have intended the necessary consequences of his own voluntary acts. Such a situation is, for example, where a person who is in a position to know the truth makes a representation as to a material matter which is untrue. In such cases the intent to deceive may be found from the fact that the representation was false without further proof of actual intent. Moreover, the intent is regarded as conclusively proved and a finding that there was no such intent will be disregarded.

Consequently if a person making a false statement had shut his eyes to the facts or purposely abstained from inquiring into them, it would be held that he had no honest belief in their truth and was just as fraudulent as if he had knowingly stated that which was false. This rule was first definitely enunciated by Lord Herschell in the British Courts in *Derry* v. *Peek* (14 App. Cas. 337), which case involved a stock

prospectus issued by directors of a company. Such a rule has been followed in general by most American jurisdictions.

In the *Ultramares Case* it was to determine whether or not the auditors or their agents had so closed their eyes to the facts as not to have an honest belief in their truth that the Court of Appeals sent the case back for a new trial. Judge Cardozo's position was that when the certificate on the balance sheet states that the figures in the balance sheet are in accord with the books, it is not merely a statement of opinion, but is a statement of fact which the auditors assert to be true. Judge Cardozo further amplifies this by saying that it is not sufficient that there is a correspondence between the balance sheet and the general ledger. The correspondence to be of any moment " may not unreasonably be held to signify a correspondence between the statement and the books of original entry, the books taken as a whole. If that is what the certificate means, a jury could find that the correspondence did not exist and that the defendants signed the certificates without knowing it to exist and even without reasonable grounds for belief in its existence."

The United States Supreme Court in *Lehigh Zinc and Iron Company* v. *Bamford*, 150 U.S. 665, held that if statements of fact are made " for the purpose of their being acted upon and they relate to matters which he is bound to know, or is presumed to know, his actual knowledge of them being untrue is not essential." This language refers, of course, to fraud actions and Judge Cardozo cites this Supreme Court case in support of his position that a jury would be warranted in finding fraud because of the statement " in accord with the books " used by the auditors in the *Ultramares Case*.

Thus the theory of liability for fraud has been gradually expanding. From the originally strict requirement that there must be a statement *false to the knowledge of the defendant* and made with the intent to deceive the plaintiff, the courts have progressed. They now hold that " fraud includes the pretence of knowledge where knowledge there is none," and where there is fraud the courts will allow protection to a limited number of persons impliedly invited to rely upon the statements of those who make them.

Auditors perhaps fear that they may be held guilty of fraud by some judge or jury if they have omitted or have done imperfectly one of the numerous things that they might do, but all of which, as a practical matter, it is impossible for them to do in any one audit. This is true, but it is no more true of auditors than of all business men, and no more true of fraud than it has always been of negligence.

If we interpret the *Ultramares* decision as the language seems to justify and if we may attempt to put it into ordinary straightforward statement, it seems that the sum of the whole matter is this : gross negligence may be regarded as evidence that fraud may have existed. That is to say, where a misstatement is due to gross negligence, intentional wrongdoing may be implied.

CRIMINAL LIABILITY OF AUDITORS.

Florida seems to be one of the few states which expressly have considered the liabilities of the professional auditor in their statutory schemes of regulation. The Florida law provides (L. 1927, sect. 7875) as follows :—

> " If any person acting in the capacity of an accountant shall wilfully make any false or misleading statement in writing in regard to any financial transaction or act, such person shall be deemed guilty of a misdemeanour. . . . "

So far no case has come up in the Florida courts construing this section.

The Oklahoma statute (Okla. Stats. 1931, sect. 4817) also approximates the Florida statute in that it provides " any person holding a certificate under this act . . . who shall knowingly falsify any report or statement . . . or audit . . . shall be guilty of a felony." No case has construed this statute.

The Texas Penal Code (sect. 1133) provides that " if any person practising in this state as a certified public accountant . . . shall wilfully falsify any report or statement . . . he shall be fined. . . ." No case has construed this statute.

CONCLUSION.

It is expected that the *Ultramares Case* will serve as a precedent in the United States in cases which even remotely resemble it. The decision is not in conflict with other decided cases. The judge who wrote the opinion of the court is now one of the Justices of the Supreme Court of the United States and stands exceptionally high for ability.

It may be assumed that there must be some direct relationship between the auditor and one who claims to be injured or a suit for damages cannot be maintained ; that ordinary cases of negligence will be dealt with as heretofore ; that in cases of gross negligence there will be strict inquiry into the facts to ascertain whether or not the auditor was making statements " flimsy or recklessly given or without sincere or genuine belief " ; and that the scope of employment should be taken into consideration in determining liability and the measure of damages.

SUPPLEMENT.

Since the foregoing was written the following laws affecting the profession have been enacted in the United States :—

Securities Act of 1933 (Public, No. 22, 73rd Congress), approved by the President, May 27th, 1933 :

Under our newly enacted Securities Act, practically all new commercial security issues must be preceded by statements which must be registered with federal authorities. Balance sheets and income accounts must be certified by an " independent public or certified accountant."

Under the Act the responsibilities and liabilities of auditors are considerably broadened and enlarged. It is too soon to comment in detail upon the pertinent provisions of the Act since much depends upon the regulations and rulings which will be forthcoming in due course and, eventually, upon the interpretation of the Act by our Courts.

In one particular the Act is quite specific and its apparent effect is to bring in the third-party liability to an extreme degree. It purports to give to the individual purchaser of a security the right to sue the auditor whose certificate appeared in the registered statement or prospectus—

"In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading."

Care is taken to limit the liability to "any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report of valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him."

The liability is limited (but not much) by the following :—

"In no case shall the amount recoverable under this section exceed the price at which the security was offered to the public,"

and extended (considerably) by the following :—

"The rights and remedies provided by this title shall be in addition to any and all other rights and remedies that may exist at law or in equity."

Recovery of the original purchase price by the purchaser of a security is supplemented by the following :—

"Any person who wilfully violates any of the provisions of this title, or the rules and regulations promulgated by the Commission under authority thereof, or any person who wilfully, in a registration statement filed under this title, makes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, shall upon conviction be fined not more than $5,000 or imprisoned not more than five years, or both."

Laws of Pennsylvania.

At the recent session of the Legislature of the State of Pennsylvania, the following penalty provision was enacted into law :—

(Act 1463, Session of 1933, signed by the Governor on May 31st, 1933) :—

"Any person or persons practising as accountants, public accountants, auditors or certified public accountants in this State who shall wilfully issue or permit the issuance of any false statement of the financial transactions, standing or condition of any corporation, partnership, or individual business undertaking, shall be deemed guilty of a misdemeanour and upon conviction thereof be fined not more than two thousand dollars or imprisoned for a period of not less than ninety days nor more than one year or subjected to both said fine and imprisonment in the discretion of the Court."

Discussion on Mr. Morgan's, Dr. Voss's, and Colonel Montgomery's Papers.

Mr. H. F. KEMP, F.C.A., in opening the discussion on Mr. Morgan's paper, said it was worthy of remark that when it was borne in mind that the Companies Acts had been in operation for over 70 years and that the number of audited accounts which had been submitted to shareholders must have reached almost astronomical figures, the occasions had been comparatively few upon which it had been found necessary to take the opinion of the Courts on questions affecting the correctness of the accounts and the manner in which auditors had carried out their duties in connection with them. Another difficulty confronting the auditor lay in the fact that it was not easy to reconcile some of the observations of the Judges in their reviews of the cases submitted to them for decision, and the legal views sometimes cut across the almost universally accepted accountancy practice in regard to certain matters, for instance, in relation to provision for the amortisation of the cost of a leasehold property. Bearing in mind that the Act which now governs limited liability companies only came into operation at the end of 1929, there was much to be said in favour of the view that any amendment to the Act was premature and that fuller practical experience of its working should be gained before making any attempt to modify it. Two of the recommendations in the report of the Society of Incorporated Accountants and Auditors referred to were to the following effect :—

"That the profit and loss account should show the true balance of profit and loss for the period covered by such account."

"That in the profit and loss account any debits or credits which are abnormal in character or extraneous in their nature to the ordinary transactions of the company, together with any reserve from a previous period no longer required, should be stated separately."

Such provisions might conflict with a practice which was not unknown in many large undertakings and while it would be conceded that they would clarify a point on which there was considerable difference of opinion and would also relieve auditors from the necessity of forming judgments in many delicate situations, was it equally certain that such provisions would on the whole be to the advantage of the trading community and, in consequence to the shareholders? Suppose, for instance, that the directors of a manufacturing company were confronted with the early termination of a trade agreement which had for some years been in operation between themselves and their competitors, including some foreigners, and which was unlikely to be renewed, and they desired out of profits of a year to set aside a substantial sum to secret reserve to strengthen the hands of the management to meet the rate war with which they might be threatened. The disclosure of this appropriation on the face of the accounts would involve the risk of precipitating the very event which the directors, in the interests of the company, were most anxious to avoid, and yet the absence of some such secret fighting resource might well endanger the very existence of the company. Examples of the same kind could readily be multiplied. For accounts to be in such circumstances issued to shareholders without any reference to these appropriations would be wrong, but would not the reasonable requirements of the case be met by making it clear in cases where the disclosed profits of the year had been depleted by transfers to some contingency account that the balance shown was "after making provision for contingencies?" To put directors too much into leading strings in such a matter might destroy their initiative and might tend to deter men of light and leading from undertaking the duties and responsibilities of such offices. Notwithstanding some notorious misdemeanours, the records of the past, on the whole, justified reliance on the integrity, probity, ability and judgment of the men responsible for the direction of the affairs of companies rather than on the rigid formulas of Acts of Parliament. When Mr. Morgan spoke of an auditor

reporting specifically on the profit and loss account as well as on the balance sheet, did he mean that if the profit and loss account did not show in figures the *true* profit of the year the auditor must mention the amount by which the actual earnings had been diminished or increased by any transfer? This might prove to be a serious interference with the directors' discretion, who, after all, were the elected appointees of the shareholders to manage businesses in the best interests of the shareholders. In the report of the Society of Incorporated Accountants and Auditors it was admitted that difficulties might arise in giving effect to their suggestions in the case of banking and similar institutions, and herein seemed to lie a grave objection to their adoption. It was well known that leading banks had strong internal reserves and it was a matter of common agreement that such reserves were essential to their stability and consequently to the welfare of the commercial community whom they served, but if these institutions were exempted from such clauses in the Companies Acts, it might well lead to serious confusion in view of the great difficulty of defining with precision the nature of all institutions to which the exemption should apply and the temptation that would arise to bring other enterprises within the scope of the definition. (Applause.)

Mr. E. VAN DIEN, F.S.A.A. (Holland), in opening the discussion on Dr. Voss's paper, said he might be allowed to ask whether it was quite correct to have papers read on "The Auditor's Responsibility . . . from the British, the Continental and the American points of view." It was possible to judge of such responsibility in relation to the laws of various countries. It was only in Great Britain that a uniform jurisdiction existed, giving final decisions binding on the whole country. The matter became a little more complicated when speaking of the American point of view, as the various states of North America had each their own legislation, administered and interpreted by the Court of Appeal of each individual state. Nevertheless, he could quite imagine that one could speak of the American point of view, seeing that in many respects the United States formed a unity. But in his opinion it was quite impossible to speak of a continental point of view if by continent one meant the continent of Europe, which consisted of some thirty countries, each having its own legislation, its own history and its own culture. Mr. Morgan's first recommendation was that the profit and loss account should show the true balance of profit or loss for the period covered by such account. That proposal, however well it might be meant, said little. The conditions were complied with when one side of the account contained in *one* amount the balance of a profit and loss account. The other recommendation was worded more precisely, namely, that in the profit and loss account any debits or credits which were abnormal in character or extraneous in their nature to the ordinary transactions of the company, together with any reserves from a previous period no longer required, should be stated separately. It was, however, striking that he immediately continued: "I ought to add, however, that some directors and others responsible for the management of public companies, would assert that compulsion to adhere to this principle in all circumstances would not be in the best interests of shareholders." And here they came to one of the causes of the problem, to which attention might be drawn separately. Reference was repeatedly made to the interests of the shareholders and to the necessity of giving them full information. And even in the address to the jury in the *Royal Mail* trial, Mr. Justice Wright asked: "If shareholders do not know and cannot know what the position is, how can they form any view about it at all?" He (the speaker) questioned whether it was necessary to let the shareholder know the ins and outs of everything. The position of shareholders with respect to joint stock companies was quite different from that of partners in a firm. At any moment shareholders could liquidate their interests in a company, and did so as soon as they saw any advantage in it. Information given to the shareholder was often nothing else than information given to the speculator, whose one wish was to make as much money as possible out of the company and then to transfer his interests to others. He did not endorse the opinion of Dr. Voss that "we are responsible not only to the company, but also to its executives, to the shareholders, to creditors and to the public"; it seemed to him that this opinion was not serviceable as a scientific formula for the responsibility of the accountant. The more one considered the problem the more it proved to be impossible to define this responsibility otherwise than in a very general sense. Colonel Montgomery stated the situation correctly when he said that "the service of the auditor chiefly consists of rendering an opinion," and that "where there is negligence there is liability." But he rightly postulated at the same time that "what may be held to be negligence in one case may be excusable in another." Dutch legislation, although couched in very general terms, contained, in his opinion, sufficient stipulations for the responsibility of the accountant. By Articles 1401, 1402 and 1403 of their Civil Code it was stipulated that every unlawful deed by which damage was caused to another placed the person through whose fault the damage had been caused under an obligation to indemnify, and, further, everyone was responsible, not alone for the damage caused by his own deed, but also for that which he had caused by his negligence or carelessness, and for that which had been caused by the deed of persons for whom he was responsible. A logically consistent application of these stipulations was, in his opinion, sufficient for all countries to punish those who, through negligence, fell short in their duties as auditors, and even held them responsbile for the negligence of their subordinates. Not only negligence, but also design fell within the meaning of these stipulations. (Applause.)

Mr. JOHN PARTON, F.C.A. (Canada), in opening the discussion on Colonel R. H. Montgomery's paper, said the first point that struck him in Colonel Montgomery's address was that there appeared to have been very little in the way of statutory enactment in the United States regarding audits or auditors' reports. That was very different apparently from the position either on the continent of Europe, in the British Isles or in Canada. It was the common experience of all Canadian practitioners to find clients expecting the auditor to assume considerably more duties and responsibilities than would ordinarily be expected in countries where the profession had been more definitely and firmly established, at any rate than it was in Western Canada. Another difficulty with which they in Canada were confronted was the unfamiliarity on the part of some of their Judges regarding auditors' work. Canada had nine provinces, each of which had its own Companies Act, in addition to a Dominion Companies Act. All these Acts differed in many materials. Most of them, however, required balance sheets to be drawn up in a certain manner, and to disclose certain specified things. The requirements for auditors' reports to shareholders under the Dominion Companies Act were exactly the same as those in the British 1907 Act, quoted in Mr. Morgan's paper. The Manitoba Companies Act had two clauses in similar terms, with a further clause in which the auditor was expected to say "whether all the transactions of the company that have come within his notice have been within the objects and power of the company, to the best of his information and belief." He believed the other Provinces had similar clauses in the case of ordinary companies. These latter clauses gave those of them who were in Manitoba some little trouble, because originally it did not include the rider "to the best of his information and belief," and Counsel's opinion was that the auditor must report in the words of the Act, making a definite statement that transactions were or were not within the power of the company, and not just expressing an opinion. Representations were made to the Government of the Province, which finally resulted in the qualifying clause being added. The Canadian Bank Act had a somewhat similar requirement, and various Provinces had also enacted legislation of a similar nature regarding trust and loan corporations. Ontario went further than any other Canadian Government and required the auditor to state that, "after due consideration, he

has formed an independent opinion as to the position of the corporation; that, with his independent opinion so formed and according to the best of his information and explanations given to him, he certifies that, in his opinion, the statement sets forth fairly and truly the state of the affairs of the Corporation; that all transactions of the corporation that have come within his notice have been within the powers of the corporation." Many opinions had been expressed by various practitioners on the meaning to be attached to that phrasing, and the responsibilities in which the auditor was involved. Personally, he was of opinion that the newer phrasing was simply emphasising the fact that, if an auditor gave an opinion, it must be his own independent opinion, and not anyone else's, which did not appear to him to be really different from the older expression. Colonel Montgomery spoke of the "Balance Sheet Audit." They had generally come to the conclusion in Canada that there was no such thing as a "Balance Sheet Audit" contemplated by the statutes. In conclusion, he said that Canadian accountants did not take a narrow view of their duties by sticking to the letter, "which killeth," but tried to act "with the spirit, which giveth life." (Applause.)

Mr. E. FURNIVAL JONES, F.C.A., F.S.A.A., said he had once heard a wise saying from someone who was not unknown to those present to the effect that they should not practise what they preached because if they succeeded it might only result in bringing their principles into contempt. He did not say that meaning that they should not have any principles, but as a warning against the bad habit of preaching. (Laughter.) Under the circumstances he thought perhaps it was wiser to stick to generalities and naturally he was most interested in the British point of view, and he would like to congratulate Mr. Morgan on his historical survey of the responsibilities of the auditor and he also believed the ideals expressed by him would meet with the general assent of all. In his paper Mr. Morgan had used the time-honoured definition of an auditor being the shareholders' watchdog. He was afraid, in that connection, of auditors becoming too much like his own pet dog, who now only barked when the bell rang. It was not quite the English view to rush too readily into legislation because legislation was often followed by differences of opinion as to what ought to be done, the ultimate decision being left to the Judges. In his paper Dr. Voss stated that legislation was provided under the new laws in Germany and he would like to wait and see the result of that legislation before they started any new legislation in this country. He thought the time should come when it should be definitely stated what qualifications the auditor should have. Another point he would like to stress was that they must also try to educate public opinion as to what a shareholder was likely to expect, and shareholders must be taught not to expect too much. (Applause.)

Mons. G. K. H. HINNEN (Holland) said he was especially interested to learn from Dr. Voss the Continental point of view, but he was somewhat disappointed when he received his paper and found that he dealt only with the conditions in Germany. When Dr. Voss said that his remarks were substantially equally applicable to the remaining Continental countries, he doubted whether that was right in all respects. He could not speak for the other Continental countries, but the ideas of auditors' duties in Holland were not quite the same as those expressed by Dr. Voss. He said: "The work of the auditor ends with the issue of the certificate and with the report to the supervisory board." In his (the speaker's) country there were many accountants who were of opinion that an auditor was also responsible for the financial communications in an annual report, which contained the balance sheet and the profit and loss account of which he approved. Regarding Mr. Morgan's paper, he fully agreed with his pleading against secret reserves, and that the auditor's responsibility for the profit and loss account should be placed beyond question.

M. LE DR. P. DRAGANESCU BRATES (Roumania) said that he desired to make a few remarks on Dr. Voss' paper regarding the responsibility of the accountant as an auditor in relation to balance sheets from the Continental point of view. Dr. Voss agreed that he had not treated the subject from the Continental point of view, because he had limited his viewpoint and dealt in a more detailed manner with the conditions in Germany. But as Dr. Voss recognised that each country had its own system of law for dealing with those matters, he thought he could have made a brief comparative research in regard to the basic conditions in France, Italy, Switzerland, Roumania, Austria and some other European countries at least. And further, he should not have regarded the auditor only as an auxiliary of the supervisory board, but as a member of that board. And that was a point upon which he would like to insist. In most countries on the Continent the members of the Supervisory Board—*Comite des Commissaires aux Comptes*—*Aufsichtsrat*—Censors, as they were called in his country—were lawyers, engineers, physicians, clericals, &c., men who had not a proper training for performing their tasks, who had no responsibility towards the body of specialists, who had no real sense of responsibility, in so far as they accepted a reward for a duty which they were not capable of fulfilling. They succeeded in Roumania in passing a law requiring that one of the censors of limited companies created after the law had passed through Parliament (July, 1921), and having at least five millions of capital, should be an accountant. He thought that that was an anomaly which should come to an end. They had to ask—as far as the Continent was concerned—that not only their responsibilities should be defined, but that none should be allowed to certify a balance sheet as correct unless he was qualified to do so. They should ask penalties from those who would assume a task for which they were aware they could be made responsible, just as they should have to pay a penalty if they signed a medical certificate.

Mons. ING J. FUKATKO (Czecho-Slovakia) said that the previous speakers had very comprehensively discussed the subject from the point of view of the legal regulations of their respective countries. He would like to add a few observations on the auditor's responsibility in Czecho-Slovakia, as well as in the other countries of Central Europe by which he meant Austria, Hungary, Poland and Yugoslavia, the legal regulations of those countries being approximately of the same structure. Up to the present compulsory auditing of balance sheets of the different companies by expert auditors had not been ordered, although the societies of expert auditors had long been trying to bring it about. According to the present legal requirements, audits of public and private limited companies were being performed by elected supervisory boards, usually consisting of three members. A member of a supervisory board or an inspector of accounts might be any person who was in possession of all rights and had been elected for the exercise of the supervising function by the general meeting. Unfortunately, unlike the practice in Great Britain, it had not become customary to appoint as members of Supervisory Boards professional auditors or expert accountants—the result being that their influence was still rather small, and it was owing to that circumstance that the institution of Supervisory Boards in public and private limited companies often failed. Under the present law the supervisory board had the duty to examine the balance sheet, the profit and loss account and the appropriation account. A report on the results of their examination must be presented to the general meeting every year. It had become customary for the supervisory board to submit to the general meeting a detailed audit report, together with the proposal to grant or refuse discharge from responsibility to the Board of Managers. Moreover, they attached at the foot of the balance sheet a special certificate in which they summarised their total audit judgment. In the wording of the certificate they found both the audit judgment, which certified the correctness of the balance sheet as to figures as well as contents, and a confirmation certifying only the numeric accordance of the balance sheet with the books. The responsibility of the Supervisory Board was two-fold—under Civil

Law and under Criminal Law. The extent of both responsibilities was laid down by the regulations ordering that the supervising activity must be exercised with the reasonable carefulness of a good business man. Under Civil Law the supervisory boards were responsible for any damage caused to the company by gross negligence on their part, and they could be prosecuted under Criminal Law if they had committed a fraudulent action in their audit report or certificate. Fuller regulations as to the contents of the audit report and responsibilities of auditors existed in the case of private limited companies. In such cases the expert auditors were obliged to submit a report in which must be stated (1) whether they had obtained all information and all explanations they had asked for, (2) whether the balance sheet exhibited a true and correct view of the financial position of the company. The content of the certificates which the expert auditors gave in that case was similar to the wording of the certificate in use in Great Britain. In addition to the compulsory statutory audit of public and private limited companies, there existed in Czecho-Slovakia the so-called compulsory autonomous audits of co-operative societies undertaken either by auditor-associations—unions—through their own expert auditors, or by auditors appointed by Courts of Justice or by the Provincial Government. A special law had laid down the rules to govern the auditors in the exercise of their duties. They had also the duty to examine the balance sheet and the profit and loss account. They were obliged to give a written report about the results as to both the material and the formal correctness. The responsibility of co-operative auditors was regulated by Common Law, and its extent was the same as in the case of supervisory boards in public and private limited companies.

Mr. J. B. WARDHAUGH, C.A., said that he was glad that the title to the papers did not restrict discussion merely to the auditors' legal liability, but embraced what was a somewhat wider subject—his responsibility. Little progress was to be made by considering merely how they might keep within the limits of their "legal liability." It was at least open to question whether a re-statement of their duties and obligations in more detailed form in a new Companies Act would be advantageous either to the shareholder or auditor. What, in his opinion, was wanted was a disposition on the part of auditors to take a broad view of their responsibilities. For example, although they might have no power to compel a company to adopt a particular form of accounts, they should exert their influence with directors to ensure that the published accounts were so framed as to be not merely "within the law," but reasonably informative to the shareholders. That particularly applied to the profit and loss account and where that account was appended to the balance sheet reported on by the auditor, there seemed to be no doubt that he was responsible for its form and content. It might be felt that their position would be easier if there was a statutory definition of a profit and loss account and what it should contain, but one had only to try to frame such a definition to realise how difficult the task of definition was, and he did not go far before he was met in one form or another with the anomaly of a so-called "true" profit and loss account, co-existent with what were in essence inner or secret reserves. On that question it would be difficult to obtain statutory enactment, but he would suggest in passing that their hands would be greatly strengthened if the Stock Exchange could be prevailed upon to make it a condition of quotation that certain specified information be given in the published accounts. A step in that direction had recently been taken by the New York Stock Exchange. In the meantime, what attitude was to be observed regarding the controversial subject of secret or inner reserves? Whatever might be the opinion as to disclosure, it appeared clear that where the profit and loss results of a year had been appreciably affected they must see that the amount of such reserve fund was disclosed in the profit and loss account, or that at least a note was placed thereon stating that such a credit had been made before arriving at the figure of profit or loss shown in the account. Again a company might not be bound at law to write down its fixed assets and it might be sufficient to indicate that they were stated "at cost," but the auditor should exercise a careful and independent judgment as to the valuation and, where necessary in the interests of the shareholders, he should express to them his opinion. Where he had strong grounds for doubt as to the sufficiency of a provision made, but was unable to express a definite opinion, it might be advisable for him to state that fact. (Cheers.)

Mr. THOMAS KEENS, F.S.A.A., said that from the general discussions which had taken place, it seemed that they had to consider broadly the question as to whether any amending legislation of the Companies Act in this country was required, or whether it was not altogether premature. He had not heard in the discussions that morning any very severe criticism of Mr. Morgan's paper or of his general conclusions, but it all came back to this: as to whether or not—referring, of course, only to the company law of this country—any further amending legislation was required so soon after an Act of Parliament was passed which only came into operation in 1929. They all knew that it was the practice of the Government of this country, in promoting legislation dealing with companies, first of all to appoint a Departmental Committee. Then, generally speaking, the legislation which was introduced was based upon the report of that Committee and followed very directly upon it. Nobody denied for a moment that the Committee which was appointed prior to the Bill which ended in the passing of the Act of 1929 was a very strong Committee. The accountancy profession was very well represented on it. It did its work admirably, but he and others who formed the Special Committee appointed by the Society of Incorporated Accountants to consider the Act of 1929 in the light of subsequent happenings came to the conclusion—indeed, were forced to the conclusion—that if the Committee had had in front of it when it was sitting, the information which was now at the disposal of all, it was much more than probable that its recommendations would have been different in character. He also said this: that it was utterly impossible, in the present state of the profession in this country—in spite of everything they believed of the standing of their colleagues and the independence which they manifested—it was utterly impossible for the smaller man who was not in the position of unquestioned superiority and eminence occupied by the larger firms, to take the attitude of extreme independence which the situation required unless he was backed up by Act of Parliament. (Applause.) They therefore suggested that it was not premature that the Government should be asked to appoint another Committee in the light of recent happenings, and that among the things which it should deal with would be the problems which were dealt with in the report. In addition to that, he (Mr. Keens) wished to suggest that steps should be taken so to protect the position of the auditor that even the smallest man who had to fight for his bread and butter would be able to stand up and occupy the position of independence which he ought to have. (Applause.) No one desired that auditors should shirk responsibilities in any way. As a profession they did not desire to shirk responsibility, but they did ask that, in assuming those responsibilities and in carrying out their duties to the public they should have the protection and support of an Act of Parliament. In his view, amending legislation was now required and should be proceeded with. (Applause.)

Mr. CHARLES REID, C.A., said Mr. Morgan had described with great care a recent case—the *Royal Mail Steam Packet* case—and had proceeded to draw conclusions from it. In his opinion there were no new conclusions affecting auditors to be deduced from that case, first, because the accounts in question were issued prior to the 1929 Companies Act, and secondly because auditors always had been definitely responsible that the figure which was stated as the profit or loss for a period was as true and correct a figure as was possible to ascertain in the circumstances of each case. If the balance sheet was correctly stated, it followed that the profit and loss balance was also correctly stated. Respecting

secret reserves, he could see no breach of accountancy principles, nor of auditor's duty, in regard to the non-disclosure of such reserves, except in cases of abuse. There was just one question he would like to ask the writer of the paper: Whether he would regard as untrue, balance sheets and profit and loss accounts which did not take into account the unrealised appreciation in fixed asset values, and the difference between the cost price of current assets and their equivalent cash realisation values. The main point on which he disagreed with Mr. Morgan was his proposal that further responsibility should be placed on auditors by means of legislation. Was he not confusing two distinct issues: (1) the amount and nature of information given in the published accounts of companies, and (2) the position of the auditor in relation thereto? The Company Law Amendment Committee in 1926, after hearing most representative evidence, came to the conclusion "That the great majority of companies in this country are honestly and conscientiously managed." The report also commented on the fallacy in the idea which prevailed in many quarters that fraud or lesser malpractices in relation to companies could be stopped by Act of Parliament. (Cheers.)

Sir JAMES MARTIN, F.S.A.A. (Vice-President of the Congress), said he wished, in common with the speakers who had preceded him, to express his acknowledgments to Mr. Henry Morgan, Dr. Voss and Col. Montgomery for their able contributions towards the work of the Congress. They had put before them some invaluable information, and he felt quite certain that when that gathering had passed by they would all be glad to make themselves further acquainted with what those gentlemen had said and also with the contributions which had fallen from other speakers. He did not like to talk about himself personally, but he wished to make his own position clear. He thought it was only right to the Congress he should do so. He was no longer practising as an accountant, having retired from practice about two years ago, but owing to his training and long association with the profession he was endeavouring to fulfil that useful purpose to which His Royal Highness Prince George had referred in his speech—to be the accountant member of some boards of companies and to endeavour to look after the interests of shareholders who had some millions of capital invested in them. But he felt that in everything he did he was indebted to the profession in which he had been brought up and in which he had passed nearly all the years of his life. Therefore he was intensely jealous of the position of the profession and of the position of the auditor which was under discussion that day. In any remarks he had to make he wished to point out that he had no concern whatever for the speculator. (Hear, hear.) The speculator added nothing whatever to the production or prosperity of his country, but put his hand into the pool in the hope that he would pull out something belonging to somebody else. Sometimes he got hurt in the attempt, and he (Sir James Martin) shed no tears for him at all. But they must not forget that the majority of the shareholders of companies in Great Britain and Ireland—to which countries he was confining his remarks—were *bona-fide* shareholders who were helping industry and commerce by making their contributions to the common capital and whose interests should be adequately protected. He considered that in these days, having regard to the complications of modern business, shareholders were really the backbone of British enterprise. He had listened carefully to the observations of Mr. Fitch Kemp, who bore one of the most honoured names in their profession. (Hear, hear.) But he did not agree with Mr. Fitch Kemp's conclusion in one respect. He was making only this one reference to a report which Mr. Fitch Kemp brought to their notice—the report on the Companies Act, 1929, of the Society of Incorporated Accountants and Auditors—to which he (Sir James Martin) had been very glad indeed to put his name. He was not prepared to withdraw anything to which he had appended his signature. There was also one point on which he did not altogether agree with what his friend, Mr. Keens, had said that morning. The question was not before Congress whether they desired or did not desire fresh legislation. If the Government set up a Committee to consider whether fresh legislation was desirable or not, then they had got to show that they did not fear any investigation that might be made into the manner in which auditors had discharged their duties. (Hear, hear.) Mr. Keens had referred to the last Companies Committee—the Greene Committee—and it was perfectly true that in the evidence taken about the year 1925 certain practices which disclosed themselves in what he would call the disastrous boom of 1927-28 were not, of course, brought before the Committee, nor could they be. What happened during that boom had not been forgotten by the public and had seriously disturbed public confidence, not in their profession, but in the administration of certain companies, with which Mr. Morgan had so ably dealt. He was speaking subject to correction, but he did not think that any auditor had been condemned, either by a Criminal or a Civil Court, since the 1929 Act of Parliament came into force. Did they not think that their proper course would be to say to the authorities: "In any inquiry you make we are willing to attend and give you any assistance in our power"? It was not the business of the Congress to put forward any scheme, but they in Great Britain should make their position absolutely clear—that they did not fear any investigation which might be made as to the manner in which their duties had been discharged. In conclusion, he wished to refer to the observations of his friend, Mr. Charles Reid, on secret reserves. No one in the Congress had a greater respect for Lord Plender's opinion than he, but side by side with Lord Plender's opinion was the statement of Lord Wright—then Mr. Justice Wright. He would just read two or three lines from it regarding secret reserves. "They may work very well in many cases. The practice has been followed no doubt by many concerns of the highest standing. On the other hand, it may be the subject of almost intolerable abuse. Such a system may be used to cover up negligences, irregularities and almost breaches of faith." Surely a statement like that, coming from a Judge of the position of Lord Wright, could not be put lightly on one side. He (Sir James Martin) felt that if a case was made out for further inquiry into the administration of companies, the duties of auditors and any analogous questions, they, as members of the profession, should welcome the opportunity of showing the faith that was in them and the manner in which they had discharged their duties. (Applause.)

Mr. F. WOOLLEY, F.S.A.A., said Mr. Morgan had taken a broad and generous view of the duties of auditors. He made no attempt in his paper to limit them by circumscribed language of Acts of Parliament. He placed upon those duties a moral consideration which they would agree must always find a very strong place in their consideration of those matters. Discussion had centred very largely upon the question of reserves, to a lesser extent upon the contents of profit and loss accounts and in some measure on the question of legislation. He (Mr. Woolley) would express one opinion only in regard to legislation, and it was that he thought it was generally recognised that the 1929 Act had been found insufficient in certain respects from the point of view of the conduct of companies, the publication of their balance sheets and the responsibilities of auditors. So long as they were clear as to what those defects were, then there need surely be no hesitation in pressing for any new legislation that might be necessary to put the matters upon a satisfactory footing. The subject upon which he desired to offer just one or two brief further observations was that of reserves, and he was speaking only of that class of reserves which they regarded as being free reserves. A somewhat loose interpretation of a single sentence in Mr. Justice Buckley's judgment in the case of the *B.S.A. Company* had seemed to lead to an exaggerated view as to the liberty that might be taken in the drawing up of balance sheets. Prudence was always required in the valuation of assets and the statement of liabilities—prudence to see that assets were not over-valued and that liabilities were not understated. But if a company had a free reserve which was equivalent to any considerable proportion of its capital, hidden away in the expression "General

Creditors," then it could scarcely be said that such a balance sheet disclosed all the material facts in relation to the financial position of the company, or that it was a true and correct balance sheet. He felt personally that if it was acknowledged that the utilisation of reserves for purposes of dividends should be disclosed, then it was very difficult indeed to apply any other rule to the creation or the existence of reserves. (Cheers.)

Mr. ROBERT ASHWORTH, F.C.A., F.S.A.A., said the public had learned to rely upon the reports and certificates of professional accountants and they must be extremely careful lest that reliance turned to distrust, for while human nature remained as it was, directors would always endeavour to put the best possible face upon their published balance sheets and accounts and use their full persuasive powers to get a clean report from the auditor upon them. They must at all costs avoid taking the line of least resistance if they desired to retain the confidence of shareholders. He submitted that it was no part of the duty of the auditor to protect directly the interests of shareholders. His duty was to place the shareholders in a position to protect themselves. That he would do if he conscientiously carried out his statutory duty, and he could not be doing his duty if he gave a clean certificate in respect of a balance sheet which did not in fact show the true and correct view of the company's affairs. Then again, there were other interests in respect of which the auditor had no statutory duty, but which he could not, in his opinion, afford to dismiss from his consideration lightly—the interests of the general investing public, who might be induced by the published balance sheet and profit and loss account and the auditor's report to become shareholders, but who would not, or might not have done so had they not relied upon the auditor's report. Also, there were the interests of the creditors to consider. Mr. Morgan had done a great service to the public in once again throwing the searchlight upon the bogey of secret or internal reserves, for there was no doubt that, while in many cases the creation of these internal reserves was effected in the supposed best interests of the concern, yet they were utilised to an alarming extent to cover up the effects of bad management. If a reserve was necessary for any purpose which it was considered not in the best interests of the company to publicly disclose, there was nothing to prevent it being disclosed as a general reserve, or reserve for contingencies, unless the utilisation of such reserve was also to remain undisclosed, which, in his opinion, should on no account be permitted. If it was seriously contended that the justification for the creation of secret reserves was that the real position was better than that disclosed by the published accounts and balance sheet, then it was quite logical to assume that the non-disclosure of the utilisation of these reserves could not be justified on the ground that the published accounts and balance sheets would then show a better state of affairs than in fact really existed. Non-disclosure of internal reserves and their utilisation, with very few exceptions, was more in the interests of the directors than in the interests of the shareholders.

Mr. R. WILSON BARTLETT, F.S.A.A., said that in making a last survey of the three papers which were under discussion that morning, certain disjointed words and phrases continually recurred to his mind. For example, "Trust and trustworthiness," which they had on Monday morning; "Co-operation and Competition," which they had on Wednesday night; a "Game of Football—Accountants were the Referees in the game of Commerce." He allowed his mind to wander, and found himself making a review of a game of football which commenced with an incident on the playing fields of Rugby in the year 1823, when William Webb Ellis caught the ball and ran with it—against all the rules of the game. In those early days the game was far different from that which was played to-day. It was a game of hard scrimmaging, pushing, no heeling back; hacking and tripping were all within the rules; and another small point, which might be quite unknown to the present generation—the maul in goal. But by a gradual and judicious amendment of rules, the game as played to-day had been evolved. And in memory I stood on the field at Rugby and watched that wonderful centenary match between the four Home Countries, when 30 players and a referee combined to give a perfect exhibition of co-operation and competition. That was accomplished as a result of amended rules, and a strict and logical interpretation of those rules, both by players and referee. The analogy could be applied to commerce. In commercial life during the past few years, especially since 1925, there had been some tripping, some hacking and several "mauls in goal." The rules of the game, represented by Acts of Parliament, had been found to be inadequate in certain respects. No one desired panic legislation, but representatives of commerce and professional accountants should welcome any inquiry which might be set up to ascertain whether any amendments to the Companies Acts were required in order that directors and shareholders should know exactly their duties and responsibilities, and also that professional accountants might know how those rules and regulations should be interpreted. Professional accountants and the investing public should congratulate Mr. Morgan on his tenacity and courage in the firm stand he had taken during the last two or three years. (Cheers.)

Mr. F. LINDSAY FISHER, F.C.A., said Mr. Morgan's paper on the auditor's responsibility divided itself under three heads: past, present and future. Regarding the past, some of the enactments and dicta to which reference had been made had been superseded to such an extent that it was refreshing to have them recalled to memory. When Mr. Morgan came to the present time he was still on fairly safe ground. He gave extracts from recent judgments and opinions from leading counsel and others, which they in England had not yet had time to forget, and which must be of interest to those members of the profession who came from abroad. Mr. Morgan also expressed some views of his own in the second part of his paper, with which, for the most part, he expected the majority of those present would agree. But in one or two instances he would venture to express a different opinion. For example, after stating that leading accountants had expressed the following view: "Provided the creation, existence or utilisation of a reserve is noted in the accounts, the non-disclosure of the actual amount is justifiable," Mr. Morgan went so far as to give his personal opinion that such a view was not consistent with the statutory form of the auditor's certificate. He (the speaker) would much rather accept Lord Plender's remark (quoted by Mr. Morgan), which was as follows: "In my opinion directors should be entitled, in the interests of the company and its shareholders, to make reasonable provisions for contingencies and should be allowed discretion in so doing without necessarily being required to disclose the amount of the provisions in the balance sheet." Later in his paper Mr. Morgan appeared not to differentiate between trading and capital losses suffered by a subsidiary. He stated: "If shares in a subsidiary company were shown at cost, it would be true, but if a part of the capital of such subsidiary company had been lost, judged by sound commercial and accountancy principles, the item would not be correctly stated." "It is my view," said Mr. Morgan, "that if the losses of a subsidiary are not dealt with by reducing the amount at which the investment appears or by making proper provision on the liabilities side of the balance sheet, the auditor should call attention thereto in his report." It should be noted that Mr. Morgan did not limit his remarks to trading losses of the subsidiary; in fact, it would almost seem that he was referring specially to capital losses—his remark came under the heading of balance sheet, not profit and loss account. He should like to ask Mr. Morgan if he would consider it an auditor's duty to require revaluation, for example, of the figure at which goodwill stood in the balance sheet of the subsidiary. If so, apparently he and Sir Josiah Stamp were of one mind, but he thought they stood almost alone in their view. It was not, however, until Mr. Morgan came to his third division, namely, the future, that there was room for serious divergence of opinion. Mr. Morgan, and the Society of which he was such a prominent member, pleaded for new legislation

and quoted the concluding paragraph of a report of his Society, which stated that the only effective action must be by amending legislation. Mr. Morgan gave his personal views as to the form which amending legislation should take respecting the duties of the auditor. He ventured to differ fundamentally from Mr. Morgan and his Society. He submitted that so far from the only effective action being necessarily amending legislation, the wisdom of our legislators and their advisers had been shown by their restraint. Auditors could not be made efficient by Act of Parliament. If an auditor conscientiously carried out his duties, the less he was hampered by rules and regulations the better. What was proper in one case might be quite wrong in another. He sincerely hoped that, when the 1929 Act was amended, our legislators would continue to show their wisdom by saying as little as possible on the subject of the duties of the auditor.

Mons. ALEXIS ROCHE (France) said the French delegation thought that it would be interesting for the delegates to the Congress to know the actual position of the auditor's responsibility in France. The obligation for all limited companies to have their accounts checked was the result of the rulings of Articles 32, 33, 34 and 35 of the law of July 24th, 1867, the substance of which was as follows :—

> Article 32. The Annual General Meeting appoints one or several auditors—partners or others. These auditors are instructed to draw up a report for the General Meeting to be held the following year on the standing of the company, the balance sheet and the accounts submitted by the board of directors.

The resolution covering the approval of the balance sheet and the accounts was null and void unless it had been preceded by the auditors' report.

> Article 33. During the three months preceding the date provided for in the by-laws for the General Meeting, the auditors have the right, whenever they deem it advisable in the common interests of the company, to examine the books and acquaint themselves with the operations of the company.

In urgent cases the auditors had at any time the right of convening a general meeting.

> Article 34. Companies shall prepare every six months a statement on their position, showing assets and liabilities. This statement is to be placed at the disposal of the auditors. An inventory shall also be taken annually in accordance with Art. 9 of the Commercial Code. This inventory shall show the value of movables and immovables as well as all the debts (assets and liabilities) of the company. The inventory, the balance sheet and the profit and loss account are to be placed at the disposal of the auditors on the fortieth day at the latest before the general meeting.
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> Article 35. At least a fortnight before the general meeting every shareholder has the right to acquaint himself with the inventory and the list of shareholders at the head offices of the company. Every shareholder is also entitled to a copy of the balance sheet, including the inventory and the report of the auditors.

The auditors constituted the controlling factor in the interests of the shareholders. The appointment of the auditors for the first business year was an essential condition of the regular constitution of the company. The general meeting alone had the power to elect the auditor or auditors, whose name could not appear in the by-laws of the company. The particular object of this ruling was to prevent the founders from nominating the persons whose duty it would be to control their operations as directors. The auditors were the mandatories of the shareholders, and could accordingly be dismissed by the general meeting. The law did not require the auditors to be either shareholders or to belong to any particular profession, but the functions of auditors could not be performed by one of the managers of the company. Many French companies appointed as auditors professional *experts-comptables* (certified public accountants). The essential duty of the auditors was to draw up a report for the annual general meeting of shareholders on the standing of the company, the balance sheet and the accounts produced by the board. Should this report not be read, the approval of the balance sheet and the accounts by the shareholders was null and void. The auditors could also convene a general meeting in urgent cases. The auditors assumed a dual responsibility, firstly towards the company, and secondly towards third parties. They were responsible to the shareholders for their mistakes or negligence, and the Tribunal de la Seine had decided that they could not plead incompetence with a view to avoiding legal measures instituted against them. They were responsible only for their personal mistakes and not for those committed by directors. Any mistake committed by an auditor involved his civil responsibility, and, under given circumstances, his penal responsibility, *e.g.*, in the event of any criminal act of which the directors had been guilty and which had not been duly reported by the auditors. The limitation of the responsibility of auditors was a period of three years, if it was a criminal case, and thirty years in other cases. Auditors were likewise responsible to third parties for their actions. At first glance it might appear astonishing that auditors were obliged to consider anybody else but the companies for whom they were acting as mandatories. In point of fact the law of 1867 did not provide for any responsibility towards third parties. However, almost all doctrines and jurisprudence admitted responsibility towards third parties; in practice the responsibility could not be avoided. The legal foundations of a conception of this nature originated from Article 1382 of the Civil Code, which had a general bearing upon the matter. It read as follows :—

> "Every act whatsoever of a person that harms any other person places the former under the obligation to make amends."

The speaker concluded by giving particulars of alterations which were being considered with regard to the duties of auditors of *Societes Anonymes*.

Mr. WILLIAM CASH, F.C.A., said he would like to join with other speakers in acknowledging the value of the papers which had been placed before Congress that morning. He wished to deal particularly with Mr. Morgan's paper, which he thought all would agree was a careful and useful summary of the points affecting the practice of accountants to-day. Mr. Morgan had dealt with the responsibility of auditors, particularly in relation to the profit and loss account, and he thought he was not misinterpreting him when he said that he gathered Mr. Morgan's view to be that to-day their responsibility, both in fact and practice, extended to the profit and loss account. Mr. Morgan had used a number of phrases with which they would all be in agreement. In relation to the profit and loss account he spoke of "actual earnings" and of "correct results as a whole"; that the profit and loss account should show the "actual results"; it should be the "profit earned" and on "sound and proper lines." The difficulty arose when they considered whether those matters could be better defined and regulated by Act of Parliament, and he (Mr. Cash) would here interpose this one observation: that where accounts were untrue or statements were misleading, under certain circumstances there were remedies which existed outside the Companies Act, and those remedies had been applied and had produced serious results for those who had been responsible for such misstatements. Again with regard to the profit and loss account, while it was no doubt true that the earning capacity of a company was the best test of its value in the majority of cases, they could all think of cases where mere ownership of itself might be of real value, apart from earning capacity. He wished to turn next to the subject which had been so much in the public eye of late, and that was the question of secret reserves, or, as one speaker had called them, free reserves. He (Mr. Cash) thought really there was a difference between the two definitions. Sir James Martin had given them some very weighty observations to which they all attached the

greatest possible importance. He had read from Mr. Morgan's paper part of the remarks of Lord Wright, but he (Mr. Cash) thought they should read those remarks as a whole. While Lord Wright said that secret reserves might be in some cases a source of danger, he also said in the preceding words that they might be of the greatest value—or words to that effect. On the question of the disclosure of such things as secret reserves, there were points which they must not overlook. One was that the mere disclosure might be of no real value to the shareholders. Mr. Morgan appeared to deal specially with the question of banks. Let them imagine a large contingency fund in the hands of a bank. Would it be of the slightest value to the shareholder to know that that contingency fund was a quarter of a million, half a million, or a million? How could such a shareholder know whether that contingency fund was really required, and to what extent it was really required in relation to the assets? The question of secret reserves was closely bound up with the question of the profits of the year, and he would suggest that the question of such disclosure was very largely a matter of degree. It would be extraordinarily difficult to control such a point by Act of Parliament. For example, income tax recovered in a year was a receipt of that year, but it might be an exceptional matter. When they came to deal with such general terms as extraneous receipts and extraneous expenses, or exceptional receipts and exceptional expenses, the accountant might be placed in a very difficult position. He (Mr. Cash) was here taking rather a different line purposely from some of the previous speakers, and would give some examples of the sort of difficulty which would arise if an attempt were made to define those matters by Act of Parliament and of the difficulty in which an auditor would be placed if an attempt were made to bind him by specific definitions. Take the question of a stock reserve, or written down value of stock; was it to be regarded as a secret reserve? Then take a reserve in the hands of a subsidiary company, or undivided profits of a subsidiary company—was that a secret reserve? Take such a case as a guarantor of a capital issue as to dividends or capital. He might think it wise to make provision for default. Was that an extraneous debit? And if not required, was that an extraneous credit or receipt? Companies varied enormously in their operations and in their character. Take such a question, for example, as a contract guarantee, either as regards the fulfilment of the duties of a particular machine or of constructional work extending over a period. Was that a secret reserve? It might or might not be required in the future, and when the period of guarantee expired the amount was brought back again. Take, too, the question of a big contractor, such as a shipbuilder or a bridge builder, who had to apportion his profits on the best estimate he could over his financial period, and who made reserves till the completion of the work. Was that a secret reserve? Take the question of an exchange reserve. Was it to be assumed that this would be secret if the reserve were made in the year for which it was not required? Then if there was an appreciation of the local currency and a credit arose, was that an extraneous receipt or was it a profit of the year? Take, too, a reserve for deficiency on liquidation, where doubt existed as to the solvency of the debtor. Was that a case where transfers into or out of a reserve would have to be specially dealt with? Mr. Morgan had pointed out the difficulties that might arise on the legal issues, and he (Mr. Cash) did not think they should be entirely disregarded. The assets of a subsidiary company and the profits of a subsidiary company were not the property of the holding company, and the liabilities of the subsidiary were not entitled to rank against the assets of the holding company. He ventured to think in that respect that they might get a misleading impression as to the result of the company's business if those things were treated by Act of Parliament in a particular way. (Applause.)

Mr. RUSSELL KETTLE, F.C.A., said that the discussion on Mr. Morgan's paper seemed to him to be developing on the lines not so much as to what was necessary for the protection of the shareholders, but as to what was necessary for the protection of the auditor. That was not a point of view they ought to emphasise. They ought to be prepared to take their responsibilities, and those responsibilities would be in direct inverse ratio to the rules and regulations which might bind them, and might easily detract from the usefulness of their services which he thought it was recognised they had rendered in the past. The subject of secret reserves had been so fully dealt with that he would only say that it did not seem to him, in the light of decisions of the Court and observations of Judges, that secret reserves were without merit or were inimical to the interests of shareholders. He thought they should not get into the way of regarding them as necessarily or at all conveying criminal intent on the part of directors, whose objects in the creation of such reserves were the protection of the business, and in the protection of the business, the protection of the shareholders. Mr. Cash had dealt with the profit and loss account, a point which he had also intended to develop. It was very easy to say that an account must be a true account, and that the results must be actual results, but when they came, in the course of their experience, to interpret those phrases there were a great many difficult problems, and the view of accountants was not always the view which business men would accept. It was not so much a question of true profit as the appropriate balance of profit and loss account. There were frequently matters to be considered which were not easy of solution. However much they might try to define what a profit and loss account should contain, he was afraid there was no wording which would cover every conceivable circumstance. He would content himself by saying that it was easy to prescribe rules of a wide and general nature, but their ambit and application were frequently highly controversial and a strict compliance with the letter might result either in ridiculous situations or in defeating the specific object which was sought to be achieved. Professional auditors were much more competent to form a view as to whether the profit for the period was an appropriate profit than was the legislator by means of rules which could never cover all the circumstances which auditors met with in practice. Finally, he wished to say that, although he differed in some respects from the conclusions in the paper, he nevertheless appreciated that Mr. Morgan was guided by considerations which appealed to them all, and that was to so improve the form of presentation of accounts that criticisms, which might have had some justification in the past, might be avoided. (Cheers.)

Mr. L. J. DAVEY, F.I.A.A., said the speech made by Mr. Keens expressed so adequately what he had in mind that he felt he could not possibly add anything to it. At the same time, he was very glad to have an opportunity, as a younger member of the profession, of adding his modest contribution to the deliberations of the Congress. Mr. Keens had demonstrated how slowly alterations of the law could be effected. It was generally conceded, he thought, that practice must progress in advance of legislation, and an auditor, if he was to fully discharge his duties, must go further than a mere compliance with the letter of the law and must use his personal judgment as to what matters needed clarification or amplification. Moral values were not always the same, even among auditors. If auditor A, contrary to the views of the directors, held the opinion that a balance sheet, although perfectly in accord with the law, needed some alteration or explanation, while auditor B saw no need for such alteration, then A probably lost a client and B gained one—a mercenary view, perhaps, but he used it to illustrate his point, which was that there should be uniformity of practice, which he suggested could only be achieved by the drawing up by the leaders of the profession of a code of rules, dealing with some of the more important questions which it was recognised that the law had failed to clarify. By so doing, two purposes would be served: first, uniformity of procedure; and second, the removal of what he believed was a growing tendency on the part of the public generally to regard published accounts with suspicion as being either uninformative or actually misleading.

Mr. JEAL, said he wished to reinforce Mr. Morgan's remarks when he said that over the last 20 years there had been a distinct tendency to reduce the amount of information given, and had used this remark in connection with the development of mergers. He (Mr. Jeal) had recently been making a study of the published accounts of a certain type of business in this country, covering about 14 years, and he could honestly say from that inquiry that, quite apart from the question of mergers, there had been a distinct tendency for the detail shown in accounts to be reduced. He had also noticed the great attempts which were made to obscure positions which obviously should be quite clear. From Dr. Voss's paper one considered the potentialities of the law, and although for Continental purposes the law might be a useful adjunct, he (Mr. Jeal) doubted its effectiveness in this country, where tradition was relied upon more than man-made laws. He wished to supplement this view by a reference to American procedure, and he thought that those experienced in American and Canadian accounting would agree with him that it was much clearer than most others. Yet, so far as he knew, the law in the United States was much less rigorous than in many other places. The reason seemed to him to lie in the fact that so many great British pioneers, like Sir Arthur Lowes-Dickinson, went over there and established a tradition for clearness in financial statements. Furthermore, in the United States he believed the chief accountant, usually called the "financial controller," had wider administrative rights and duties than was the case in some other places. He therefore suggested to the Congress that possibly one might modify the law by arranging for the chief accountant to share, in a fiduciary sense, the responsibility of the auditor for the financial statement. That would raise the status of the financial controller, which was highly desirable. He did not think that they should prescribe the exact details, but the auditor and financial controller should be responsible that the statement was reasonably clear.

Mr. H. G. HOWITT, F.C.A., said the problems resolved themselves largely into three categories—the profit and loss account, secret reserves and subsidiary companies. Respecting the profit and loss account, they were all agreed, he hoped, that if the profit and loss account did not show earnings it must not be so worded as to convey the impression that it did; if it did purport to show earnings, extraneous items, if material, should either be indicated or shown separately as occasion demanded, and, as between different accounting periods, revenue should be stated on a reasonably uniform basis. An auditor who did not see that such rules were complied with did so at his peril. That position represented a substantial advance and one which it would have been difficult to attain by law. What further could be done? They might specify, even by legislation, that certain items must be shown separately, *e.g.*, income tax, depreciation, income from investments and income from subsidiaries. Personally he saw no objection to that, and he would watch with interest the German experiment in that direction. At such gatherings as that Congress they could even clear their minds as to what they meant by profits and losses; but could such a definition be codified in a manner suitable for an Act of Parliament? It would involve laws as to methods of depreciation, stock valuations, &c., which he thought could never be adequately treated by such means. Regarding subsidiaries, they were agreed on certain points, but what further could be done? As accountants they might like to see all subsidiary profits and losses so far as ascertainable brought into the holding company's accounts, but the complications in some cases, arising, as they did, out of the varied nature of holdings and even out of variations in accounting method between the companies concerned, were so considerable that it was doubtful whether an Act of Parliament could effectually specify them. He would prefer a little more effort by the commercial and accounting community on these particular points before trying further, and perhaps hasty, legislation.

LORD PLENDER said that with much of what was said in Mr. Morgan's paper he was in entire agreement. He had prepared it with great care, had marshalled his authorities with clearness, and his conclusions, whether they agreed with them all or not, were entitled to consideration and respect. He congratulated him on his contribution, which was of great value. There were two aspects of his paper to which he wished to refer very briefly and in a practical way as time was short: first, the auditor's position as regards transfers to or from profit and loss to inner provisions or reserves. If directors in the honest exercise of their judgment set aside a sum or sums for unmatured but possible contingencies to which the business was subject, and which they thought necessary in the best interests of the company, few, if any, auditors would question the desirability, if not the obligation, to see that the profits were stated after referring to such provisions having been made. It did not follow, however, that an auditor in reporting on the accounts would feel it to be his duty to state in his report the actual amount so set aside if the directors thought that in the company's best interests the amount should not be disclosed, and they themselves refrained from doing so. Nor if such sum (or accumulations of such transfers) were included in an omnibus item on the debit side of the balance sheet, and the fact was clearly stated that it was so included, would an auditor necessarily consider it to be his duty to mention the amount in his report if the directors, acting to the best of their judgment and again in the shareholders' interests, refrained from stating the amount. An auditor, if consulting his own wishes only, would like to see in many cases fuller disclosure and more informative accounts; but he was not responsible for the form in which the accounts were submitted to the shareholders. His duty was to report to the members of the company, and if he thought they were misleading in their presentation—after taking into due consideration the phraseology adopted by the directors in describing how profits or losses had been arrived at, or collective figures stated in the balance sheet—then he should inform the shareholders. But when profits of a year were supplemented or losses lessened or turned into apparent profits by transfers from contingency provisions that were found to be no longer required—and became, in effect, therefore, free reserves—or current revenue charges were debited thereto—then it might be said that different considerations arose and it would require very cogent reasons for the amounts not to be disclosed. But general principles, as he had tried to illustrate, sound and unassailable as they might seem to be, could not in all conceivable conditions be regarded as sacrosanct, and he would not care to dogmatise on the subject. Secondly, he was very doubtful as to the desirability of compelling by legislation all commercial and industrial companies to disclose in every case the amounts transferred from or to the profit and loss account as previously referred to by him. Once compulsion was established by law there could be no exception, whatever the circumstances might be, and it might be that, apart from the transfers themselves, difficulties would arise in the application of the principle such as in the writing down of stocks, in provision for doubtful debts, in the valuation of frozen credits or balances, and in many other directions of which Mr. Cash had given illustrations. The directors in their review of assets for balance sheet purposes might have their discretion and their judgment disturbed by what they thought was the full meaning and effect of such legislation, and the caution and discernment they exercised for the permanent good of the company, and therefore of the shareholders, would be affected. Whilst auditors might have their views, directors also had their views, and they might not correspond. The auditors were not the managers or administrators of a company's affairs. The directors were appointed for that purpose by the shareholders, to whom they were accountable, and before legislation of the nature indicated was contemplated, there should at least be a very thorough inquiry and the considered views heard of managing directors and other members of boards of very large and important companies whose businesses were not free from serious hazards and risks which often required anticipatory action; and in such an inquiry, if held, auditors of experience would only be too glad to assist. (Applause.)

Mr. Morgan's Reply.

Mr. HENRY MORGAN, F.S.A.A., replying to the discussion, said he wished to thank, very briefly, the many speakers for their generous expressions regarding his Paper, and they must not regard the brevity of his thanks as the measure of his very great appreciation of what they had said. It would be impossible for him to reply to all the speakers; therefore he would chiefly refer to the principal issues which had been raised in the course of the discussion. First of all there was the question of amending legislation. Some speakers strongly supported that suggestion, while others had evinced equally strong opposition to it. He would ask the latter, were they satisfied with the present practice in regard to companies' accounts? It must be obvious to anyone who studied the provisions of the 1929 Act that its intention and its spirit was to ensure greater and reasonable information to shareholders. There were the provisions which set out in detail the form of a Company's Balance Sheet. Those provisions had been in a great many cases completely nullified by the rapid growth and extension of the Subsidiary Company principle. They could recall many cases where a very large part of a Company's capital—sometimes amounts equalling the whole—had been transferred to Subsidiary Companies: and what was the result? A cloak was drawn right across that part of the shareholders' capital and how it was represented. The inefficient provisions of the Act with regard to Subsidiary Companies had, in his opinion, made the position worse than it was before the passage of the Act, because many people read into those provisions some sort of legislative sanction for the ignoring of accountancy principles. The question of the Accounts of Public Companies was a very serious one for their profession, because unless abuses which were obvious were eliminated, it must tend to destroy public confidence in the value and reliance to be placed on the accounts they certified. With the law and practice as at present, how much could shareholders regard as being definitely implied by the Balance Sheet, with an Auditor's certificate, of a company whose capital was largely represented by interests in subsidiaries? Shareholders could be satisfied that there was nothing irregular in connection with the accounts and affairs of the holding company, but it did not necessarily follow that there might be nothing in connection with the affairs of the subsidiary companies, which, if they had occurred in connection with the holding company, would have been brought to the notice of the shareholders. It did not necessarily follow that the true and correct position of the holding company was shown by its balance sheet. Of course, all legal requirements would have been complied with, but the position of the company must be dependent to a very large extent upon the value of the interests in subsidiary companies, and with regard to the subsidiary companies the information was of so vague a character that there could frequently be little reliance upon the correctness of the value stated. One must bear in mind that with regard to subsidiary companies and their results the auditor had no direct concern; that, by the Act, was the concern of the directors, by whom the statement regarding their profits and losses had to be signed. Then with regard to the Profit and Loss Account, it did not necessarily follow that the true result was shown in such account. They knew that the most frequent method regarded as compliance with the Act was to bring in the profits of subsidiary companies only to the extent of dividends declared. Those dividends might be paid out of the profits of the year; or they might be paid out of profits of other years; or, again, there might be big profits remaining undistributed in the subsidiary companies. Therefore it was always a matter of doubt, where subsidiary companies existed, as to whether a Profit and Loss Account could be relied upon as showing the actual result of the company's operations for any year. The question was sometimes asked, "What is the value of a balance sheet in view of the present law?" In his opinion it was vitally important to members of the accountancy profession to use their efforts to get the unsatisfactory provisions of the law amended. Touching upon the question of secret reserves, Mr. Kemp, in his observations, had given them a hypothetical case where a balance sheet, drawn up with the definite intention of concealing information affecting the position of the company, had resulted in material benefit to shareholders. History was full of cases where great success had followed as a result of actions which could not be justified on any other grounds than the success which had attended them. It was a promulgation of the doctrine that the end justified the means. He (Mr. Morgan) wished to say that he, for one, did not subscribe to it, and in his opinion it would be a dangerous doctrine for accountants to follow. Mr. Kemp had also suggested that the extent to which Accountancy principles might be departed from was a question of degree. Again he did not agree, because he believed that where a question was involved as to what was right and proper, any consideration as to degree should not arise. With regard to the Profit and Loss Account, some speakers had indicated their objection to extending the Auditor's report to that account as he (Mr. Morgan) recommended. He could understand one of the chief reasons which might underlie that objection. He would give it in a word or two—secret reserves. As regards the balance sheet, a secret reserve, so long as it existed, could always be regarded as consistent with the view that an auditor was justified in certifying a balance sheet as true and correct, even though the actual position might be considerably better. That doctrine if accepted could always be justified so long as the reserve existed and it was not affected whatever fluctuations in such reserve might take place. But when they came to the Profit and Loss Account it operated quite differently. The result disclosed by the Profit and Loss Account would always be at least as good as the actual, so long as the secret or internal reserve was increasing. But once there was a fluctuation in a downward direction, then that doctrine did not apply because the result disclosed by the Profit and Loss Account was better than what it actually was. Thus there arose a special difficulty with regard to the Profit and Loss Account so long as it was affected by any secret reserves. The difficulty in practice was sometimes met by "indicating" that accountancy principles had been departed from, either by some more or less vague phraseology in the wording of the Balance Sheet or Profit and Loss Account or sometimes by some innocent-looking qualification in the Auditor's certificate. Shareholders and the public frequently did not realise the significance to be attached to any qualification in the report of the auditor. Therefore he maintained that it should always be made quite clear in every case where sound principles had not been adhered to. Mr. Cash in his remarks had indicated cases where difficulty might occur in regard to dealing with certain matters which arose in connection with accounts, but it appeared to him that these related to provisions which it was necessary and proper to make and were distinguishable from what he had referred to as reserves. In his paper he had endeavoured to point out very clearly the distinction between "reserves" and "provisions" which had to be taken into account in arriving at the result shown by the Profit and Loss Account. Those provisions, in his opinion, it would not as a general rule be necessary to state separately, but he did urge that anything in the nature of a free reserve which affected the result shown by the Profit and Loss Account should be disclosed, both at the time of its creation and its utilisation. Mr. Fitch Kemp had asked a question with regard to the disclosure by the Auditor of the amount by which the Profit and Loss Account might be over or under-stated. It was not the duty of an Auditor to rectify accounts. He had stated very clearly in his paper that if an auditor had to qualify his certificate regarding the balance sheet he should make it clear in what respect he took exception to it, but that it was not his duty to state the amount involved. In his (Mr. Morgan's) opinion, exactly the same principle would apply to the Profit and Loss Account. Mr. Lindsay Fisher had referred to his suggestion regarding amendment of the law as to the duties of auditors. In his (Mr. Morgan's) opinion the duties of the

auditor regarding the Profit and Loss Account should be defined, as in the case of the balance sheet. He had stated that to extend it to the Profit and Loss Account meant no greater responsibility than in the case of the Balance Sheet, and if it was so provided for by law it would remove some doubt which might at present exist. Much had been said that morning about the directors' point of view, but there was also the shareholders' point of view. Auditors were described as the watch-dogs of the shareholders, and they had to form their own opinion. They had always to consider the views of the directors, but if there were ground for the view that auditors were unduly swayed by the opinions of the directors rather than expressing their own independent opinion as to the correctness and truth of the Balance Sheet and Accounts, it could only tend to affect the confidence of shareholders and the public. It seemed to him that some alarm existed regarding any extension of auditors' responsibilities. He, for one, would not fear an extension of responsibility provided always that the responsibility placed upon them was fair and reasonable and that it was clearly defined, both as to extent and nature. He would conclude his observations by saying that in his opinion the fulfilment of the destiny of the accountancy profession was not to be sought in the avoidance of responsibility. (Applause.)

Mr. Voss's Reply.

Dr. W. Voss (Germany) said he desired to thank those speakers who had referred to his paper. He would have been surprised if the discussion had not revealed differing opinions. He thought it was right it should have done so, for it would not have been interesting if they were all of the same opinion. He would conclude with the hope that the discussion might be to the benefit of the profession they all loved so much.

Colonel Montgomery's Reply.

Col. R. H. MONTGOMERY (U.S.A.) said he must ask the President to exercise his high prerogative and continue the proceedings for another week; otherwise he would have to ask his friend, Mr. van Dien, to withdraw one of his remarks. For many years, commencing with the First International Congress at Amsterdam, they thought they had built up a very good code of professional honour, but Mr. van Dien now told them that they had practically no duty whatever to shareholders. (Laughter.

The CHAIRMAN said that from the discussion to which they had listened, with interest, it was evident that there existed a measure of disagreement. That did not surprise him in the very least. The world would be very dull indeed if all men of intelligence agreed upon all points. What, however, had impressed him more than anything else was the fact of their unanimity in ideals and objectives, before which the importance of agreement as to methods of attaining them sank into insignificance. He was certain that if and as long as they retained their determination to serve their fellow men in all countries as effectively as they possibly could, and in all humility and singleness of purpose explored every avenue that might lead to that goal, their efforts would not be in vain. There remained to him the duty and pleasure of according to Mr. Morgan, Dr. Voss and Col. Montgomery the hearty thanks of the meeting. (Applause.)

SOCIAL FUNCTIONS.

Reception at Grosvenor House.

Following the Address of Welcome in the afternoon of Monday, July 17th, a reception was given in the evening at Grosvenor House to the delegates and visitors from abroad. The guests were received by Lord and Lady Plender and Sir James and Lady Martin in the large Ball Room. During the evening a buffet supper was served, and selections of music were played by the Band of H.M. Grenadier Guards, under Captain G. J. Miller, Director of Music (by kind permission of the Colonel Commanding). An entertaining cabaret performance was given about 11 o'clock.

Lord and Lady Plender's Garden Party.

On Thursday afternoon, July 20th, the delegates and visitors from abroad and members of the Executive Committee of the Congress were entertained by Lord and Lady Plender at a Garden Party at Ovenden House, Sundridge, Kent.

Arrangements were made for the transport of the visitors from Grosvenor House through an interesting part of Kent, and they arrived at Ovenden by about 4 o'clock.

Lord and Lady Plender received the guests on the lawn immediately in front of Ovenden House, which is a beautiful specimen of English period architecture —part William and Mary and part Tudor.

Musical selections were given by the Band of the Royal Air Force and the guests were afforded an opportunity to see the grounds, farm and paddocks of the estate.

The kind hospitality of Lord and Lady Plender afforded the visitors from abroad an opportunity of seeing a delightful English home and of meeting one another and the hosts of the Congress in an informal way.

The guests returned by road from Ovenden at about 5.30 p.m.

Visit to the Port of London.

On Thursday, July 20th, a party of about a hundred found that a trip down the Thames was a particularly enjoyable way of spending a very hot July day. The party was accompanied by Mr. T. Haworth, F.S.A.A., chief accountant to the Port of London Authority, and by Mr. E. K. Holmes, assistant publicity officer. The journey as full of interest, affording a wonderful glimpse of the part played in the United Kingdom trade by one of the greatest ports in the world, which extends for a distance of approximately 69 miles—from Teddington to the sea. At Tilbury the company disembarked and enjoyed an excellent lunch at the Tilbury Hotel. Mr. John Myers, F.C.A., presided, and expressed the thanks of the company to the Port of London Authority for affording the facilities for the trip and for the excellent arrangements that had been made. Mr. Haworth briefly replied. On the return journey a visit was paid to the King George V, the Royal Albert and the Royal Victoria Docks, which comprise 245 acres—the largest sheet of enclosed dock water in the world.

Ball at Grosvenor House.

The closing function of the Congress in London was a ball at Grosvenor House, at which some 800 visitors and members of sponsoring bodies were present. Lord and Lady Plender and Sir James and Lady Martin received the guests promptly at 10 p.m., and dancing commenced immediately and continued until 3 a.m., the music being furnished by the Embassy Band.

Members of sponsoring bodies brought parties of personal guests to meet the visitors from abroad

and there were a number of enjoyable supper parties during the evening. This brilliant function afforded much enjoyment to all who participated and was a delightful conclusion to a memorable Congress.

The following are the names of those who organised and attended the Congress proceedings :—

OFFICERS AND COMMITTEE.

PRESIDENT.—Lord Plender.

VICE-PRESIDENT.—Sir James Martin.

SECRETARY.—The Hon. George Colville.

ASSISTANT SECRETARIES.—Mr. R. W. Bankes and Mr. A. A. Garrett.

EXECUTIVE COMMITTEE.—Mr. H. L. H. Hill, F.C.A. (Chairman), Mr. H. Morgan, F.S.A.A. (Vice-Chairman), Mr. J. C. Burleigh, C.A., Mr. W. Cash, F.C.A., Mr. A. E. Cutforth, F.C.A., Mr. E. Cassleton Elliott, F.S.A.A., Mr. Thomas Keens, F.S.A.A., Mr. H. F. Kemp, F.C.A., Mr. J. C. Latham, F.L.A.A., Mr. Charles Reid, C.A., Mr. R. S. Stokes, F.C.A., Sir Nicholas Waterhouse, F.C.A., Mr. F. Wilson, F.C.R.A., and Mr. James Wood, C.A.

DELEGATES.

AFRICA.—Mr. Robert Hemphill, Mr. W. E. Moxley, Mr. J. H. Elwes Wilson.

AUSTRALIA AND NEW ZEALAND.—Mr. H. B. Allard, Mr. Will Appleton, Mr. R. H. Butler.

AUSTRIA.—Herr Fritz Spohn.

CANADA.—Mr. F. G. Blackstone, Mr. A. L. Crampton Chalk, Mr. H. R. Clark, Mr. C. V. Gladwell, Lt.-Col. H. D. Lockhart Gordon, Mr. M. O. Haskell, Mr. J. Hyde, Mr. John Parton, Mr. T. H. Rathjen, Dr. J. W. Ross, Mr. D. J. Walker, Mr. R. Williamson.

CHINA.—Mr. C. W. Porter.

CZECHO-SLOVAKIA.—Mons. Kamil Augsten, Mons. Ing. J. Fukatko, Mons. Ing. J. Fuksa, Mons. J. Teply, Mons. Ing. Jar. Zimmer.

DENMARK.—Mons. C. Jesperson, Mons. J. P. Strobel.

FRANCE.—Mons. Marc Barbut, Mons. R. Bès de Berc, Mons. Emile Buriat, Mons. Roger Jollet, Mons. C. L. Lejeune, Mons. René Martin, Mons. Léon Retail, Mons. Alexis Roche, Mons. H. Sénéchal.

GERMANY.—Herr Adolf Becker, Herr Dr. Walther Düring, Herr Wilhelm Kollmar, Herr Dr. Rosenberg, Herr Dr. Walram Schiffmann, Herr Dr. Paul Schourp, Herr Melchior Schwoon, Herr Dr. Johann Semler, Herr Dr. Wilhelm Voss.

GREAT BRITAIN.—Mr. S. C. Berger, Mr. W. H. Boddington, Mr. H. W. Buckingham, Mr. R. Dunkerley, Mr. R. K. Hardy, Mr. J. A. Lacey, Mr. E. E. Mills, Mr. D. M. Muir, Mr. W. H. Stalker, Mr. R. A. Wetherall.

HOLLAND.—Mons. G. K. H. Hinnen, Mons. M. Pimentel, Mons. James Polak, Mons. F. Rinsma, Mr. E. van Dien, F.S.A.A. (President, Second International Congress on Accounting), Mons. M. F. C. Van Teeseling, Mons. H. J. Volkers.

ITALY.—Signor Alfreho Selvi, Signor F. Soletti.

JAPAN.—Dr. Kotaro Fujimoto.

MEXICO.—Señor R. Casas-Alatriste, Señor Alfredo Chavero.

NORWAY.—Mons. P. I. Borch, Capt. K. Haanes, Mons. C. Sommerschild.

PHILIPPINE ISLANDS.—Señor Vicente Fabella.

POLAND.—Mons. S. Wojciechowski.

ROUMANIA.—M. le Dr. P. Draganescu Brates, Mons. N. Butculescu, Mons. Arthur Holban, M. le Prof. G. L. Trancu Iasy, Mons. Simion Stefanescu.

SWEDEN.—Mons. L. T. Bohlin, Prof. O. Sillén, Mons. S. Svensson.

SWITZERLAND.—Mons. A. Fahrni-Lenz, Mons. Fritz Kläy.

UNITED STATES OF AMERICA.—Mr. Alexander Banks, Mr. John Berg, Mr. C. P. Carruthers, Mr. W. Sanders Davies, Mr. A. S. Fedde, Mr. H. B. Fernald, Mr. J. F. Forbes, Hon. D. L. Grey, Mr. E. H. Griswold, Mr. F. F. Hahn, Mr. James Hall, Prof. H. R. Hatfield, Prof. David Himmelblau, Col. R. H. Montgomery (President, Third International Congress on Accounting), Dean J. C. Myer, Mr. George S. Olive, Mr. Maurice Peloubet, Mr. A. P. Richardson, Mr. Charles F. Rittenhouse, Mr. W. A. Staub, Mr. Andrew Stewart, Mr. Arthur C. Upleger, Mr. James F. Welch.

VISITORS.

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Incorporated Accountants' Students' Society of London and District.

The Committee of the above Society under their Prize Scheme have awarded prizes to the following members of the Parent Society who took honours at the examinations held in May last :—

FINAL EXAMINATION.

First Prize of £10 10s.: Mr. B. C. Cornes, who took Second Certificate of Merit.

Second Prize of £5 5s.: Mr. J. R. Paramour, who took Third Certificate of Merit.

INTERMEDIATE EXAMINATION.

First Prize of £5 5s.: Mr. A. P. G. Walters, who took Fourth Place Certificate.

Second Prize of £3 3s.: Mr. J. H. Gadsden, who took Fifth Place Certificate.

MUNICIPAL CORPORATIONS (AUDIT) ACT, 1933.

The following is the text of the above Act :—

POWER OF BOROUGH COUNCIL TO VARY EXISTING PROVISIONS AS TO AUDIT.

1.—(1) In any borough in which the provisions of this sub-section are adopted—

(*a*) the accounts of the corporation and the accounts of the borough treasurer and other officers of the corporation shall, instead of being audited by borough auditors in accordance with the Municipal Corporations Act, 1882, be audited by district auditors in like manner as accounts of an urban district council and its officers, and the enactments relating to audit by district auditors and to all matters incidental thereto and consequential thereon shall apply in like manner as if they were herein re-enacted with the necessary modifications ; and

(*b*) sections twenty-five, twenty-six and twenty-seven of the Municipal Corporations Act, 1882, and section two hundred and forty-six of the Public Health Act, 1875, shall cease to be in force.

(2) In any borough in which the provisions of this sub-section are adopted—

(*a*) the accounts of the corporation and the accounts of the borough treasurer and other officers of the corporation shall, instead of being audited by borough auditors as aforesaid, be audited by one or more auditors appointed in accordance with the Schedule to this Act, and the provisions of that Schedule shall have effect with respect to the qualifications, powers and duties of any auditor so appointed ; and

(*b*) section twenty-five of the Municipal Corporations Act, 1882, shall cease to be in force, and references to borough auditors in section twenty-seven of that Act and to auditors of the borough in section two hundred and forty-six of the Public Health Act, 1875, shall be construed as references to the auditor or auditors so appointed.

(3) The provisions of subsection (1) or of sub-section (2) of this section may be adopted in any borough by means of a resolution of the council of the borough in that behalf, being a resolution—

(*a*) passed by a majority consisting of not less than two-thirds of the members of the council present and voting at a meeting called for the purpose, of which not less than one month's previous notice has been given to every member of the council; and

(*b*) confirmed by the council at a regular meeting held not less than one month after the passing of the resolution.

(4) Any resolution passed and confirmed for the purposes of this section shall take effect in the case of a resolution adopting the provisions of subsection (1) of this section as from such date as the Minister of Health may by order direct and, in the case of a resolution adopting the provisions of subsection (2) of this section, as from such date as may be specified in the resolution.

INSPECTION AND COPIES OF REPORTS.

2. Every local government elector for a borough in which the provisions of subsection (1) or subsection (2) of section one are adopted may at all reasonable times, without payment, inspect and take copies of and extracts from any report of the district auditor or other auditor or auditors thereunder appointed.

SHORT TITLE AND EXTENT.

3.—(1) This Act may be cited as the Municipal Corporations (Audit) Act, 1933.

(2) This Act shall not extend to Scotland or Northern Ireland.

SCHEDULE.

ALTERNATIVE PROVISIONS WHICH MAY BE ADOPTED AS TO AUDITORS.

1. The auditor or auditors shall be appointed in writing under the seal of the corporation for such period and on such terms as to remuneration and otherwise as the council of the borough think fit.

2. No person shall be qualified to be so appointed unless he is a member of one or more of the following bodies, namely:—

The Institute of Chartered Accountants in England and Wales;

The Society of Incorporated Accountants and Auditors;

The Society of Accountants in Edinburgh;

The Institute of Accountants and Actuaries in Glasgow;

The Society of Accountants in Aberdeen;

The London Association of Certified Accountants, Limited;

The Corporation of Accountants, Limited.

3. Any auditor so appointed shall be entitled to require from any officer of the corporation such documents, information and explanations as may be necessary for the performance of his duties.

4. Any auditor so appointed shall include in or annex to any certificate given by him with respect to the accounts audited by him such observations and recommendations (if any) as he thinks necessary or expedient to make with respect to the accounts or any matter arising thereout or in connection therewith.

Society of Incorporated Accountants and Auditors.

South African (Eastern) Branch, Durban.

ANNUAL DINNER.

The Chairman of the Eastern Branch, Mr. DOUGLAS MACKEURTAN, F.S.A.A., presided at the first annual dinner of the branch held at the Royal Hotel, Durban, on June 7th.

Among the company present were His Worship the Mayor of Durban (Councillor O. Lea), Mr. J. M. Graham (Chief Magistrate of Durban), Mr. R. Gray (Receiver of Revenue, Durban), Mr. T. Eriksen, C.A. (S.A.) (President, Durban Chamber of Commerce), Mr. H. B. George, A.S.A.A. (Provincial Auditor, Natal), Mr. J. S. Woodhead (Incorporated Law Society of Natal), Mr. H. L. Crockett, C.A. (S.A.) (Natal Society of Accountants), Mr. W. R. Fraser, F.S.A.A. (Honorary Secretary, Eastern Branch), and a large number of members and articled clerks.

Mr. G. E. L. HORNE proposed the toast of "Allied Professions." He was very sorry that illness at the last moment had prevented Mr. G. A. F. Brett (President of the Incorporated Law Society of Natal) from being present, but he welcomed Mr. Woodhead, who had very kindly taken Mr. Brett's place. Mr. Horne paid tribute to the legal profession in Natal, stating that the legal and accountancy professions had worked closely together, and he trusted this would continue for many years to the equal benefit of both. In the past, differences and difficulties had arisen between the South African Societies of Accountants and this Society, but these differences had now been removed, and he trusted it would be possible to work together in the closest harmony and cohesion for the welfare of the profession in South Africa.

Mr. H. L. CROCKETT, of the Natal Society of Accountants, in replying to the toast, expressed his appreciation of the work that Incorporated Accountants had done in South Africa. He stated that the Society was the pioneer society of accountancy in South Africa, and it was very largely due to the formation of its Branches years ago and to the work that the original Incorporated Accountants in South Africa had done that the profession of accountancy had reached the high standing that it had. He recorded his deep appreciation of being asked, as the representative of the Natal Society of Accountants, to be present at the first dinner of Incorporated Accountants in Natal.

Mr. T. ERIKSEN (President of the Durban Chamber of Commerce) submitted the toast of "The Society of Incorporated Accountants and Auditors." He said that as a descendant of a long line of sea captains he had desired to become a sea captain too, but he had been placed by his father in the office of a wool merchant. While there he had met the late Mr. George Mackeurtan, whom everyone present would remember as one of the finest men it was possible to know. It was his admiration of Mr. Mackeurtan that decided him that he must become an Accountant. He fully endorsed Mr. Crockett's remarks regarding the work that past and present members of the Society were doing for the accountancy profession in South Africa. He paid a great tribute to the work of Sir James Martin on behalf of the Society, stating that it was largely due to visits by Sir James to South Africa that a Branch of the Society was formed at the Cape in 1894, followed in 1902 by the Transvaal branch, which absorbed the old "Institute of Accountants and Auditors in the South African Republic" and in 1928 by the establishment of the Eastern Branch in Natal.

Mr. A. E. HURLEY, F.S.A.A., in replying, said that he was fully conscious of the honour given to him to respond to the toast of the Society, and, in thanking Mr. Eriksen for the very kind reference made to the Society, he did so, not only on behalf of the South African Eastern Branch, but on behalf of the Society as a whole.

Mr. G. E. NOYCE, F.S.A.A., proposed "His Worship the Mayor of Durban and Guests." He stated how grateful Incorporated Accountants of the South African Eastern Branch were that His Worship the Mayor had been able to spare some of his valuable time to attend their first dinner, and how grateful they were to have with them the other guests. Mr. Noyce said that he paid tribute, not only to the high offices held by their guests, but also to the great ability which had enabled them to attain to their high offices. He was particularly pleased to welcome to Natal Mr. H. B. George, the recently-appointed Provincial Auditor, who was also a member of the Society, and who had, until a few months ago, been a member of the South African Western Committee.

The MAYOR OF DURBAN responded. He said he was very pleased indeed to be present at the first dinner of the Branch. He did not know whether in the past he had been fortunate or unfortunate, as he had had very little to do with Accountants. He had, however, within the last two years been in close touch with certain members of the Society in regard to the problems arising on the abandonment by Great Britain of the gold standard, and the advice given to him had always been most sound and helpful. He was indeed pleased to attend the dinner that night as he had a very pleasant task to perform: he had been asked to present the gold medal awarded by the Society to Mr. W. D. Bramwell, of Messrs. Halsey and George's office. As no doubt all present knew, a gold medal was presented by the Council of the Society to the clerk obtaining the most marks in the Society's Final examinations each year. It was the highest award the Society could make to a clerk. It was very gratifying to him, as Mayor of Durban, to know that the gold medal had only been awarded twice to South Africans, and both recipients had been Durban men. (Applause.) In 1912, Mr. Douglas Mackeurtan, the Chairman of the dinner that evening, had been awarded the gold medal—(hear, hear)—and now it had been awarded to Mr. Bramwell, whom he wished to congratulate most heartily. Mr. Bramwell had tied for first place with Mr. F. J. Riches, of Norwich, England. He wished him every success in his future career. Mr. W. D. Bramwell, amidst much applause and enthusiasm, was then presented with the gold medal.

ANNUAL MEETING.

The fifth annual general meeting of the South African Eastern Branch was held at the Royal Hotel, Durban, on June 7th, Mr. Douglas Mackeurtan occupying the chair.

The annual report and accounts were adopted, and the retiring auditor re-elected.

It was unanimously decided that a sum of £21 be sent as a donation to the Benevolent Fund of the Society.

The three retiring members of the Committee, Mr. Douglas Mackeurtan, Mr. G. E. Noyce, and Mr. A. E. Hurley, were re-elected, there being no other nominations.

Mr. H. O. Berend expressed appreciation of the work done by the Honorary Secretary, and proposed that an honorarium and office allowance be granted to him; this was unanimously agreed to.

Mr. G. E. Noyce proposed that Consultative Panels, to consist of three members each, should be appointed to deal with the following matters:—(1) Professional Conduct and Fees. (2) Insolvency Matters. (3) Audit Practice. (4) Executorship Matters. (5) Income Tax. Mr. Noyce stated that the scheme had first been proposed and adopted by the Liverpool District Society and that particulars would be found in the April issue of the *Incorporated Accountants' Journal*. He did not wish members to look upon the creation of these panels as an easy way of removing the burden of any special problem from their shoulders, but he thought that occasions might arise when they would welcome the opinion of their fellow-members who might have had much greater experience in the particular matter concerned. After a general discussion, in which a number of members joined, it was unanimously decided to create Consultative Panels as proposed by Mr. G. E. Noyce.

Extracts from Committee's Report.

The following are extracts from the annual report of the Branch:—

EXAMINATIONS.

The usual examinations of the Society were held in Durban in May and November, 1932, and the entries and the results were as follows:—

	Sat.	*Passed.*
Preliminary	3	1
Intermediate	7	6
Final	11	5

Mr. W. D. Bramwell (Durban) received the first certificate of merit and the first prize of £15 15s. at the November Final Examination. Mr. Bramwell has also been awarded the gold medal of the Society in respect of the examinations for 1932. The Committee congratulate him very heartily.

The Committee desire also to congratulate Mr. G. H. Surtees (Bloemfontein) on being awarded the second certificate of merit and the second prize at the November Final Examination.

MEMBERSHIP.

The total number of members over whom the Committee has jurisdiction was, at December 31st, 1931, 49. During the year under review, six new members have been elected, while one has been transferred from the Natal register to the English register. The total membership in Natal, as at December 31st, 1932, was 54.

CONFERENCE WITH SOUTH AFRICAN SOCIETIES OF ACCOUNTANTS.

In October, 1932, a conference of delegates from all the South African Societies of Accountants and the three branches of our Society was held at Cape Town. The delegates from the Eastern branch were Mr. G. E. Noyce and Mr. G. E. L. Horne. Various matters affecting the accountancy profession in South Africa were discussed, and amicable decisions were arrived at.

STUDENTS' SOCIETY.

At the conference held in Cape Town in October last, it was unanimously resolved that every endeavour be made to form a Students' Society in the larger centres, and that it should be made compulsory for all articled clerks to become members.

In the last annual report, the Committee were able to report that during the year 1931 a Students' Society had been started in Natal. During the year under review, several lectures have been given. The attendance of students has been fairly satisfactory, but the attendance of qualified Accountants has been poor. The Committee would be grateful if members of the Society and their clerks would take an active interest in the welfare of the Students' Society in Natal.

BENEVOLENT FUND.

Last year in general meeting you voted a sum of £15 15s. to the above fund, and you will be asked again, if you think fit, to donate a further amount this year.

Your Committee would point out that members resident in Natal are entitled to receive benefit from the Benevolent Fund in London should occasion arise.

MEMBERSHIP OF THE COMMITTEE.

The following members of the Committee retire, in terms of the Constitution of the Branch, but are eligible and offer themselves for re-election:—Mr. Douglas Mackeurtan, Mr. G. E. Noyce and Mr. A. E. Hurley.

AUDITOR.

Mr. F. E. Osborn retires, but is eligible and offers himself for re-election as Auditor of the Branch.

Changes and Removals.

The partnership hitherto existing between Mr. A. France and Mr. J. R. Moger under the style of A. France & Co., Incorporated Accountants, has been dissolved as from March 31st, 1933. Mr. A. France will continue to practise in the name of A. France & Co., at West Bar Chambers, Boar Lane, Leeds, and Mr. J. R. Moger will practise in his own name at Martins Bank Chambers, Cleckheaton.

Messrs. Nathaniel Duxbury, Son, & Co., Incorporated Accountants, have removed their offices to Alexandra House, 49, Preston New Road, Blackburn.

The partnership hitherto existing between Mr. Frank T. Goodliff, Incorporated Accountant, and Mr. Henry L. George, A.C.A., Incorporated Accountant, under the style of Frank T. Goodliff & George, has been dissolved by mutual consent. Mr. Frank T. Goodliff will continue to practise at 5A, Castle Square, Brighton: and Mr. Henry L. George will practise at 51A, St. James's Street, Brighton.

Mr. S. K. Kar, B.Sc., Incorporated Accountant, announces that he has taken into partnership Mr. S. K. Sen, Incorporated Accountant. They will practise under the style of Kar, Sen & Co., at 4, Hastings Street, Calcutta.

Messrs. Muir, Moody & Co., Incorporated Accountants, have taken into partnership Mr. Owen I. Thomas, A.S.A.A. The practice will be continued at 20, Newgate Street, London, E.C.1, under the same style as heretofore.

Mr. J. Cyril Page, Incorporated Accountant, has admitted into partnership Mr. R. D. Burnet, Incorporated Accountant, and Mr. Robert Black. The firm name of J. Cyril Page & Co. will remain unchanged, and they will continue to practise at 51, North John Street, Liverpool, and Chester Street, Mold, North Wales.

Mr. George Ridley, Incorporated Accountant, announces a change of address to Gibb Chambers, Westgate Road, Newcastle-upon-Tyne.

Messrs. John Tonge & Johnson, Incorporated Accountants, announce a change of address to 89, Fountain Street, Manchester.

Messrs. Widdowson & Simpson, Incorporated Accountants, announce that they have admitted into partnership Mr. J. F. Wreford, Incorporated Accountant. The practice will be continued at Bank Chambers, 329, High Holborn, London, W.C.1, under the style of Widdowson, Simpson, Wreford & Co.

Mr. Henry Morgan, F.S.A.A. (ex-President of the Society of Incorporated Accountants and Auditors) has been nominated by the London Chamber of Commerce to be a member of the Executive Council of the Association of British Chambers of Commerce. Mr. Morgan will take special interest in matters relating to Taxation, Commercial Law and Commercial Accounts.

INCOME TAX QUESTION.

Rent Payable to a Partner.

An income tax dispute between a firm of Chartered Accountants and the Inland Revenue Authorities came before Mr. Justice Finlay in the King's Bench Division last month.

An Inspector of Taxes (Mr. R. R. Heastie) appealed from a decision of the Commissioners for the Special Purposes of Income Tax in favour of Veitch & Co., Chartered Accountants, of Coleman Street, London, E.C., with regard to an assessment in the sum of £3,800 for the year ending April 5th, 1932.

The assessment was made under Schedule D in respect of profits arising from the business which is conducted by Mr. Horace Johnston Veitch, senior partner, and Mr. Gordon Scot Simmonds, junior partner.

Mr. Veitch purchased the leasehold interest of the Coleman Street premises, and it was used for the partnership business on the term that the partnership paid him the sum of £1,250 a year as rent. The net Schedule A assessment of the premises was £705.

The question raised by the appeal was whether the sum of £1,250 was an admissible deduction for rent in arriving at the profits of the partnership for the purpose of assessment for tax, or whether it should be only £705 as allowed by the Inspector of Taxes.

For Veitch & Co. it was contended that £1,250 was an admissible deduction, while on behalf of the Crown it was submitted that it should stand at £705 as £1,250 was not a sum laid out by the partners for the purposes of their profession, but was an adjustment between Mr. Veitch and Mr. Simmonds as partners.

The Commissioners held that £1,250 was a fair and proper rent for the Coleman Street premises, and was an admissible deduction. They reduced the assessment by £545 to £3,255, which represented the difference between £705 and £1,250.

Against this decision the Crown now appealed.

After hearing arguments Mr. Justice Finlay gave judgment allowing the Crown's appeal. There was evidence, he said, before the Commissioners, and they accepted it, that £1,250 was a fair and proper rent for the premises in Coleman Street. But what was said on behalf of the Crown was that that could not apply where they were dealing with a partnership where two persons, so to speak, paid and one received. While accepting absolutely the findings of the Commissioners that this was a fair and proper rent, he had come to the conclusion that the deduction must be restricted to the annual value, £705. Upon that ground, and not without some hesitation, he held that the findings of the Commissioners could not stand, and the appeal would be allowed with costs.

Mr. Stamp, for the Crown, mentioned that there was a second appeal by the Commissioners of Inland Revenue against Veitch & Co. which arose over the same point and raised the question that the rental of the premises should be allowed over a period of three years. That case, however, was governed by the decision just given in the earlier case.

Mr. Justice Finlay said the result of the first case would be followed in the second.

Mr. T. Donovan, for Veitch & Co., said that his clients might desire to take the case further, and he wanted to reserve the point that the whole question was one of fact which had been decided in his favour.

Review.

The Work of the Stock Exchange. *By Sir Stephen Killik. London: E. Couchman & Co., Limited, 23, Throgmorton Street, E.C.2.* (70 *pp.*)

The average member of the public knows little of the practice and procedure of the Stock Exchange. To many persons such terms as arbitrage, contango, &c., are shrouded in mystery, and even members of the investing public have little cognisance of the work entailed in the fulfilment of orders placed by them with their brokers. This lucid little book by Sir Stephen Killik will accordingly be welcomed. It is so clearly expressed that anyone with no previous knowledge of Stock Exchange practice will be able to read and understand it without difficulty. Sir Stephen has refrained from using any technical expressions without first explaining them in detail. The pamphlet contains four lectures delivered by Sir Stephen to the Institute of Bankers, and has been produced at the request of his colleagues on the Committee of the Stock Exchange. The first lecture is devoted to a historical review of the Stock Exchange and an outline of its internal working. In view of the fact that members of the public are not entitled to admission to the "House," this section of the pamphlet is of very considerable interest. The manner in which dealings are effected forms the subject of the second lecture. The functions of the Stock Exchange Clearing House, the Buying-in and Selling-out Department and the Share and Loan Department of the Stock Exchange are dealt with in detail. A further useful feature of this lecture is the summary of the accounting entries in the books of the broker. The third lecture deals with the various methods of speculation. The operations of bulls and bears are discussed in detail, and speculation by means of options is illustrated at length. The last lecture commences with an excellent exposition of arbitrage dealings, a highly specialised type of transaction of which little is known by the layman. Sir Stephen then deals at some length with Trust Companies, including the Fixed Trust, which is a recent innovation in this country. Such matters as underwriting, special settlements and dealings in shares not officially quoted are also dealt with in this lecture. In view of the wide scope of the General Knowledge Papers set at accountancy examinations, students will do well to possess themselves of a copy of a treatise on this subject prepared by such an eminent authority as the author of this work.

Society of Incorporated Accountants in Ireland.

The annual general meeting of the Society was held on June 28th at 34, Dame Street, Dublin. The President, Mr. James Boyd (Belfast), occupied the chair.

The President, in proposing the adoption of the report, laid emphasis on the very high standard required in the Society's Examinations, and said that, in his opinion, it was desirable that this standard should be maintained as, apparently, qualified Accountants were becoming more numerous than the public demand required. The report and accounts were passed unanimously.

The retiring members of the Council, Mr. R. J. Kidney (Dublin), Mr. Norman Booth and Mr. Robert Bell (Belfast), were re-elected, as also was the Hon. Auditor, Mr. T. Condren Flinn. A cordial vote of thanks to the President terminated the proceedings.

At the Council meeting held immediately after the annual general meeting, the following officers were elected for the year 1933-34:—President, Mr. R. J. Kidney, Dublin; Vice-President, Mr. Norman Booth, Belfast; Hon. Secretary, Mr. A. J. Walkey; and Hon. Treasurer, Mr. A. H. Walkey, Dublin.

District Societies of Incorporated Accountants.

LIVERPOOL.

Members of the Society visited the Hooton Aerodrome on July 5th, at the invitation of the Liverpool Aero Club. The party travelled from Woodside Ferry by motor coach and, after inspection of the aerodrome, were taken for flights by members of the club. Tea was afterwards taken in the club rooms.

A similar visit was paid by a second party of members on Saturday, July 8th.

SOUTH WALES AND MONMOUTHSHIRE.

A successful tennis tournament by members of the Cardiff and Newport Students' Sections was held at Caerau, near Cardiff, on July 12th. A silver cup, kindly presented by Lieut.-Colonel R. C. L. Thomas, the President of the District Society, was won by Mr. W. Davies, of Newport, who beat Mr. K. Sim in the final by 6—1, 6—3. It is hoped to make the tournament an annual event.

COST OF MUNICIPAL HOSPITALS.

Mr. John Allcock, O.B.E., F.S.A.A., has been appointed a member of the Departmental Committee of the Ministry of Health which is to consider and report on the questions of the capital cost of construction and the annual cost of maintenance of hospitals, public assistance institutions, mental deficiency institutions, maternity homes, and baths and washhouses, provided by local authorities. Special regard is to be paid to (*a*) the establishment and periodic revision of standards; (*b*) modern methods of construction; and (*c*) the possibility of securing a reduction in present costs without impairing the efficiency of the buildings.

The Committee is appointed in accordance with a recommendation by the Committee on Local Expenditure in 1932. The Chairman is Sir L. Amherst Selby-Bigge, K.C.B., and the Secretary, Mr. J. Topping, of the Ministry of Health.

Scottish Notes.

(FROM OUR CORRESPONDENT.)

The International Congress.

The Scottish Branch was represented at the International Congress on Accounting by Mr. D. M. Muir, F.S.A.A., Dunfermline, and Mr. James Paterson, F.S.A.A., Secretary of the Scottish Branch. Mr. Muir took a prominent part in the discussions.

Edinburgh's Codifying Order.

An interesting statement on the completion of the modernisation of all the local Acts was made at a meeting of the Edinburgh Town Council last month by Sir Andrew Grierson, Town Clerk. The Provisional Order codifies or consolidates over thirty local Acts. Two difficulties had to be overcome. The first was whether such an extensive operation would not be more appropriate for a public Act of Parliament than for a private Bill.

The other point, which, he said, was more insidious, and which they had to fight over and over again, was a disposition to bring what he called Scottish administration into line with English administration. From that point of view English administration was more under the thumb of the Governments than they found in Scotland, and in regard to a great many matters they were asked to agree to provisions being put in to the effect that

Government Departments must give their sanction. For example, they had for centuries practically enjoyed the privilege of going to Parliament when they liked, either to promote an Order, or to oppose a Bill promoted by other people. The practice in England was that the Local Authorities were not allowed to do that unless with the consent of the appropriate Government Department.

At one time he almost despaired of coming to what he thought was a reasonable arrangement with the Scottish Office in regard to a great many points which they raised, but ultimately they did arrange satisfactorily most of the outstanding questions.

Income Tax.—Employment Abroad.

An income tax dispute concerning a Greenock Civil Servant was decided in an English Court on 17th ult. Mr. E. W. C. Corry, deputy cashier of the Royal Naval Torpedo Factory, Greenock, appealed from a decision of the Special Commissioners for the special purposes of Income Tax Acts against assessments made upon him for tax under Schedule E. Mr. Corry was deputy cashier of His Majesty's naval base at Singapore for three years ended April 5th, 1930-31-32, and was assessed on the sums of £1,053 10s., £1,343 and £1,194 2s. 8d. respectively. He left the United Kingdom in July, 1928, and returned in September, 1931. He contended that, as he held an office or employment abroad during this period, his income was not subject to taxation. Further, he maintained that an official house occupied by him was not subject to taxation; that his "colonial allowance" was not subject to tax; and that he was entitled to deduct the cost of providing himself with housing accommodation from June, 1930, to April, 1931.

The Commissioners confirmed the assessment, subject to an agreed adjustment for 1930-31, with the exception of the tax on the official residence occupied by Mr. Corry for some time while in Singapore. Mr. Corry appealed against this decision, while the Crown cross-appealed upon the disallowance of tax with respect to the value of the official residence.

The appeal came before Mr. Justice Finlay in the King's Bench Division.

Giving judgment, Mr. Justice Finlay said in his view the decision of the Commissioners was a correct one, and both the appeal of Mr. Corry and the cross-appeal of the Crown failed. Assessments had always been made on the assumption that persons in the position of Mr. Corry were chargeable to income tax. He entertained no doubt that a startling revolution would be effected in the administration of income tax if he decided any other way.

Notes on Legal Cases.

COMPANY LAW.

In re Tea Trading Company; K. & C. Popoff Bros.

Winding Up Foreign Company.

Maugham (J.) held that the Court can wind up a foreign company which has carried on business within the jurisdiction, even if the company has ceased to exist, and that if there is no member, officer or servant of the company on whom the petition to wind up can be served, the service must be effected under Rule 28 of the Companies (Winding-up) Rules, 1929, by leaving a copy of it at the company's "last known principal place of business" within the jurisdiction.

(Ch.; (1933) 1 Ch., 647.)

In re Whiterock Quarries,

Execution Creditors.

In the winding up of a company, judgment creditors of the company, in respect of whose debts a seizure of the assets of the company has been made prior to the presentation of the petition for winding up, are entitled to be paid their claims in priority to the petitioner and the liquidator's costs and remuneration, notwithstanding that no sale has been effected prior to the presentation of the petition.

(K.B.; (1933) 1 I.R., 363.)

EXECUTORSHIP LAW AND TRUSTS.

In re Wavertree; Rutherford v. Walker.

Selection of Effects by Legatee.

A testator bequeathed to his adopted daughter R. such of the furniture and household effects which at the date of his death should be in or about either of his residences, H. Hall or S. Lodge, as she might select for the purpose of furnishing a residence for herself.

It was held that the legatee was entitled to select from each of the residences, that the bequest included motor cars and other effects in the outbuildings, and that, as there was no quantitive limit to the power of selection, the legatee was absolutely entitled to the whole of the furniture and household effects in the two residences.

(Ch.; (1933) 49 T.L.R., 515.)

In re Jones; Jones v. Jones.

Clear Yearly Sum after Deduction of Income Tax.

A testatrix who died on January 1st, 1930, devised and bequeathed her residuary trust funds in trust to pay to or to apply for the benefit of her daughter such annuity as, after deducting income tax therefrom at the current rate for the time being, would amount to the clear yearly sum of £350, free of duty. If there should be any surplus income in the hands of the trustees, they were to pay the same to her son. In December, 1932, the Commissioners of Inland Revenue repaid £131 12s. 7d. by way of repayment of income tax in respect of the daughter's income for the three years to April 5th, 1932. The question was raised whether that sum belonged to the annuitant, or whether so much of it as was attributable to the annuities ought to be treated as part of the residuary estate.

It was held that the testatrix had not given the annuity free of income tax. The income tax only came in for the purpose of fixing in each year the amount to be provided. The current rate meant the standard rate, not the actual rate which the annuitant might ultimately have to pay. The bequest was of an annual sum, liable to fluctuation in accordance with the movement up or down of the standard rate. If the annuitant succeeded in recovering any part of the tax paid by the trustees on her behalf, it would belong to her just as it would in the case of an annuity not bequeathed free of tax.

(Ch.; (1933) W.N., 176.)

REVENUE.

Cohen & Moore v. Commissioners of Inland Revenue.

Stamp Duty on Settlement.

A deed of settlement executed on June 24th, 1931, after reciting, as was the fact, that on May 20th, 1931, for the same consideration as was mentioned in the deed, which then existed in draft form, the settlors had verbally declared that they would thenceforth, until trustees were appointed in their place, hold the securities mentioned in the schedules thereto, being of the value of £55,344, as trustees upon the same trusts as would be set forth in respect of the securities mentioned in the third and fourth schedules thereto, being of the value of only £1,512, when the same were formally transferred, went on to witness that in consideration of matters therein mentioned, the settlors thereby assigned and transferred to the trustees the securities mentioned in the third and fourth schedules; that the trustees should stand possessed of all the property and securities vested in them upon certain specified trusts, and that the settlors thereby appointed the trustees of the settlement to be the trustees of the securities mentioned in the first and second schedules thereto.

It was held that, although the verbal declaration of trust had been made before the deed, the two nevertheless formed one single transaction, and that the deed was chargeable under the head "Settlement" in the First Schedule to the Stamp Act, 1891, with *ad valorem* stamp duty on the total value of the property mentioned in all its four schedules, namely, £56,856.

(K.B.; (1933) 2 K.B., 126.)